

## The future of arm's length principle - Is there a need to revisit the principle?

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**List of Abbreviations**

ALP	Arm's length principle
BAPA	Bilateral Advance Pricing Agreements
BEPS	Base erosion and profit shifting
CCCTB	Common Consolidated Corporate Tax base
CPM	Cost plus method
CUP	Comparable uncontrolled price
DEMPE	Development, enhancement, maintenance, procurement and exploitation
FAR	Function, Assets and Risk
HTVI	Hard to value intangibles
IFA	International Fiscal Association
IP	Intellectual property
MTC	Model Tax Convention
MNE	Multinational enterprises
OECD	Organization of economic cooperation and development
PE	Permanent Establishment
PSM	Profit Split Method
RPM	Resale price method
TP	Transfer Pricing
TPG	Transfer Pricing Guidelines
TNMM	Transactional Net Margin Method
TPG	Transfer Pricing Guidelines
US	United States
VCA	Value chain analysis

## Abstract

Under existing laws and tax treaties of most countries, TP rules are predicated on the ALP. The principle requires the terms and conditions of transactions and the allocation of profit among members of a controlled group, to be consistent with those established among similarly situated unrelated entities. Thus, the international standard is a 'separate entity' centric approach that evolved in response to changing global conditions over the last century.

However, the principle has received a lot of criticism, one reason for which is the evolution of innovative business models. Several proposals have been discussed in past which completely overlook the ALP (for ex. earlier US proposal for a Border-Adjusted Tax, the European Commission's proposal for the CCCTB and the India's draft proposal of fractional apportionment for profit attribution to PE's etc.). It seems that it is difficult to argue with the conclusion that there remains a significant level of concern about the current ALP system<sup>2</sup>, a matter that has been accentuated by the changing techniques in demand generation.

The purpose of this paper is to discuss the concept of ALP, analyze the feasibility of applying the ALP, identify the strengths and weakness of ALP and enlist some ways in which such weakness may be addressed. An attempt has been made to highlight the broad criticism that ALP, comments on the alignment of ALP with holistic value creation. The paper ends up with some open questions for the readers to ponder upon.

Keywords – Arm's length Principle, Article 9(1)

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<sup>2</sup> <http://business-taxation.sbsblogs.co.uk/2017/12/05/report-of-the-cbt-conference-on-the-future-of-the-arms-length-principle/> accessed on 27 October 2020.

## Section I: Setting up the scene

### 1. Introduction

The concept of ALP which was introduced a century ago has evolved into a legal norm of international tax law to safeguard proper allocation of profits and it forms the basis of TP legislation<sup>1</sup>. It mainly lays down an optimization mandate through which taxpayers or tax administrations applying TP rules should try to reach a solution that is as close as possible to what independent parties would have attained under similar circumstances.<sup>2</sup>

ALP still is considered as the **'...heart, spirit and foundation of the current international transfer pricing system'**<sup>3</sup>, however, the question that arises is **how efficient and appropriate is ALP rules for allocation of taxing rights in today's world.**

### 2. History of arm's length principle

The League of Nations in 1930 established a fiscal committee to study the practices/ legislations of around 35 countries concerning the allocation of income to local establishments of foreign entities. A deviation on the accounting methods for allocating profits to the local establishments with the most common approach being the presumptive taxation was reported in the Carroll report<sup>4</sup>. Thereafter, the fiscal committee of the League of Nations drafted a multilateral agreement on the allocation of business profits (considering the independent enterprises' principle) which was similar to the ALP approach.

Later, the OECD in 1956, took over this work of the fiscal committee of the League of Nations. Further, a report was issued that provided for a draft article on the allocation of profits to permanent establishments and related enterprises. This was then placed in Articles 7 and Article 9 respectively of the OECD MTC of 1963<sup>5</sup>.

Also, in the US Treasury Regulation of 1968, the arm's length standard and reliance on comparable uncontrolled transactions were furthermore elucidated and emphasized.<sup>6</sup> In 1979, the Committee on Fiscal Affairs of the OECD published its Guidelines<sup>7</sup> on the application of the ALP. Similar to the US Treasury Regulation of 1968, these guidelines also endorsed three methods for determination of ALP: the CUP

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<sup>1</sup> De Wilde 'In these early days of international taxation the League of Nations, as the 'predecessor' of the United Nations and the OECD, drafted the first Model Tax Conventions on Income and Capital' (2015), p.6.

<sup>2</sup> Aitor Navarro, Chapter 6: Conclusions in Transactional Adjustments in Transfer Pricing (IBFD 2018), Books IBFD.

<sup>3</sup> Yariv Brauner, Value in the eye of the Beholder: The Valuation of Intangibles for transfer Pricing Purposes., 28 Va. Tax Rev. 7, (2008), p. 96.

<sup>4</sup> Mitchell B Carroll, Report on taxation of foreign and national enterprises. League of Nations, Volume 1, No C. 73. M. 38. 1933. II. A, 1933.

<sup>5</sup> Pertinent to mention 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.

<sup>6</sup> Durst/Cubertson, 'Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today', 57 Tax Law Review 1 (2003), p. 52.

<sup>7</sup> OECD, 'Transfer Pricing and Multinational Enterprises' (1979).

method, the CPM and the RPM.<sup>8</sup> A further report<sup>9</sup> was issued in 1984 to consider how a multinational enterprise may be relieved from economic double taxation when transfer prices are adjusted by tax authorities, transfer pricing in the particular sector of banking, and issues related to the allocation of management and service costs for tax purposes and it supplemented the 1979 report.

The so-called authoritative statement<sup>10</sup> of the standard is found in paragraph 1 of article 9 of the OECD MTC<sup>11</sup> and has remained unchanged since its adoption. Further, although the legal basis of the ALP relies upon the domestic legislation of each country implementing it, there exist commonalities given the history of how the principle evolved in the international scenario.

### 3. Article 9(1) of the model tax convention<sup>12</sup>

As per Article 9(1) of the MTC (which contains the authoritative statement for ALP); it is a principle that applies to a controlled transaction to determine whether the price of that transaction would have been agreed on between independent parties in the open market to ascertain international income is fairly allocated. From Article 9 of the MTC, we can also conclude that it is the foundation for the comparability analysis because it initiated the requirement of<sup>13</sup>: ‘A comparison between conditions (including but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises, to determine whether the determination of profits is at arm’s length’.

The interplay of Article 9(1) (and accordingly the ALP concept) depends a lot on whether provisions are considered illustrative or restrictive. Questions have arisen in past whether Article 9(1) is illustrative or restrictive. However, views exist on both sides as discussed below:

#### (a) Article 9(1) is restrictive:

Article 9(1) should be considered as restrictive in nature as it **covers only TP adjustments and not the transactional adjustments**. (i.e. Article 9(1) prohibits adjustments to the profits of an enterprise in excess of an arm’s-length amount (for example, by denying or limiting the deduction of interest paid by a resident to an associated non-resident)<sup>14</sup>). Further, in Para 2 of the OECD MTC, it is stated that ‘**No re-writing of the accounts of associated enterprises is authorized if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm’s length basis)**’. In this regard, Professor Klaus Vogel also suggested that the **treaty provision will act only as a safeguard that any**

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<sup>8</sup> Hamaehers, ‘Arm’s Length – How Long?’, International Transfer Pricing Journal (2001), p. 30.

<sup>9</sup> OECD, ‘Transfer Pricing and Multinational Enterprises-Three Taxation Issues’ (1984).

<sup>10</sup> OECD, Transfer pricing guidelines (2017), par. 1.6.

<sup>11</sup> References made to the OECD MTC can be extended to the UN MTC as the content of Article 9(1) is the same.

<sup>12</sup> The ALP as stipulated by Article 9 of the OECD MTC: [Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

<sup>13</sup> Jelle Pleune, ‘The Desirability of the Arm’s Length Principle in the 21<sup>st</sup> Century’, p. 12-13.

<sup>14</sup> Brain J Arnold, ‘The Relationship Between Restrictions on the Deduction of Interest Under Canadian Law and Canadian Tax Treaties’ (2019) 67 Canadian Tax Journal/Revue fiscale canadienne, p.1072.

**adjustments made will not go beyond the arm's length standard**<sup>15</sup>. Hence, adjustments for an amount exceeding ALP should not be permitted. Further, even if one is to look at Article 25 of the OECD MTC, it requires the condition of 'taxation not in accordance with the provision of this convention.....' So, if Article 9(1) is not read as restrictive, **then how possibly will a primary adjustment beyond arm's length ever 'not be in accordance with the provision of this convention'?** Moreover, it would be difficult for **Article 7 to restrict the authority of a country in which a PE is located to tax an amount in excess of the arm's length profits attributable to the PE**, but not for Article 9 to do so with respect to associated enterprises; if provisions of Article 9 are not restrictive.<sup>16</sup> In this context, Wittendorff further clarifies that since Article 7(2) requires the contracting state to comply with the arm's length principle, the legal effect of Article 9(1) must be the same<sup>17</sup>.

**(b) Article 9(1) is illustrative:**

Article 9(1) in no way preclude a country from taxation of profits of its resident entities for the amount that is in excess of arm's length amount because it only provides for a non-binding statement concerning the ALP and an outline for the adjustment of profits<sup>18</sup>. There are convincing indications in the OECD MTC, in particular reference several of countries that **interpret the article such that it does not bar a profit adjustment under the nationals under different conditions**.<sup>19</sup> Further, in the commentary on Article 9(2), it is recognized that countries might tax more than the ALP of an enterprise and **indicates that in such situations, the other country might not be obliged to provide for a corresponding adjustment**<sup>20</sup>. Also in Article 9(1), the use of the **permissive word 'may' have been made instead of the use of the mandatory word 'shall'**<sup>21</sup>. In normal parlance, it is generally understood that where the use of words may have been referred, the provisions may in such situations may not be interpreted as restrictive rather they are should be interpreted as illustrative. Pertinent to mention, Article 9 is different from the other distributive rules of the treaty in that it deals with the allocation of taxing rights between two residence countries, whereas the other rules deal with the allocation of taxing rights between the source and residence countries. Nevertheless, it might be conflicting to the notion that tax treaty does not restrict a country's rights to tax

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<sup>15</sup> Reference in this regard can be placed on Klaus Vogel, Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation on Income and Capital with Particular Reference to German Treaty Practice, 3rd ed. (Kluwer), Para 7, Commentary on Article 9, p. 517.

<sup>16</sup> Johannes Becker, Ekkehart Reimer and Alexander Rust, Klaus Vogel on Double Taxation Conventions (Kluwer Law International (2015), p. 603.

<sup>17</sup> Jens Wittendorff, The Transactional Ghost of Article 9(1) of the OECD Model, 63 Bulletin for International Taxation 3, (2009), p. 112.

<sup>18</sup> *ibid*, n 10.

<sup>19</sup> OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, Commentary on Article 9 para 4.

<sup>20</sup> Reference in this regard can be placed on OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, Commentary on Article 9 para 6., p. 227.

<sup>21</sup> Georg Kofler and Isabel Verlinden, 'Unlimited Adjustments- Some Reflections on Transfer Pricing, General Anti-Avoidance and Controlled Foreign Company Rules, and the Saving Clause' (2020) 74 Bulletin for International Taxation, p.275.

its own residents unless it does so explicitly if Article 9 were to be interpreted in a restrictive manner<sup>22</sup>. This is also pertinent from the wording of **Article 1(3)** (where ever Article 1(3) is present) and Article 1(3) does not have an exception for Article 9(1).

*Comments: Prima facie, it seems that an illustrative interpretation may make Article 9(1) superfluous, thereby making its existence meaningless. Such a view may not be consistent with the primary purposes of Article 9 as well. This view was also supported in the General Report for the IFA Congress 1992<sup>23</sup>, wherein it is agreed that Article 9(1) should not be construed as being merely illustrative. Incidentally, this also seems to be the prevailing opinion in the General Report for the IFA Congress 1996<sup>24</sup>. However, with Article 1(3) i.e. saving clause in the tax treaties, it is yet to see that how the provision of Article 9(1) may be considered as restrictive with no exceptions in the relation of its applicability for Article 9(1).*

#### **4. The constant evolution of the arm's length principle**

The ALP has evolved since its initiation. First, the standard was applied with traditional methods i.e. the CUP method, the CPM and the RPM which were allowed as per the 1979 OECD Report. However, given the complications of finding comparable in a transactional basis, the methods of applying the ALP were extended in the 1995 OECD TPG to include income-based methods, i.e. the TNMM and the PSM (these were dependent more on financial ratios and profit margins). Further, the BEPS action plan 8 to 10 brought various changes in the TPG (for example - the treatment of transactions involving intangible assets (inclusion of DEMPE analysis and HTVI concept).

Hence, the development of the ALP can be divided into the pre-BEPS and post-BEPS frameworks<sup>25</sup>. The characteristics of the ALP under the pre-BEPS framework for TP analysis are as follows<sup>26</sup>:

(1) transactions **within MNE group and formalistic contracts**; and

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<sup>22</sup> Reference in this regard can be placed on OECD (2017): Model Tax Convention on Income and on Capital (Condensed version) Commentary on Article 1, para. 18 p. 59.

<sup>23</sup> Guglielmo Maisto, Transfer Pricing in the absence of comparable market prices: General Report, in IFA, Cahiers de Droit Fiscal International, (1992) Vol. 77a, p. 60-61.

<sup>24</sup> Detlev J. Piltz, International aspects of thin capitalisation: General Report, in IFA, Cahiers de Droit Fiscal International, (1996) Vol. 81b, p. 69.

<sup>25</sup> The contemporary application of the ALP in transfer pricing requires bringing 'the fiction of the separate entity approach suggested in the 1933 Carroll Report – which is at the core of the arm's length standard – as close as possible to business reality'. The requisite link to business reality would not necessarily require a departure from the current treaty framework, but rather a better articulation of tax policy with respect to MNEs. The original intent of the arm's length principle is revealed in the allocation of profit between a source country and a residence country. The intent is to align the taxable profit in a source country with the efforts, measured in various ways, required to earn such a profit. Such an alignment is similar to the analysis that has initially been undertaken with respect to permanent establishments, and that is also relevant in a separate entity setting. The issues of the current application of the arm's length principle and the potential for its enhancement in order to align the business outcomes with the value creation are analysed in the subsequent chapters.

<sup>26</sup> M. Pankiv, Chapter 6: Contemporary Application of the Arm's Length Principle in Transfer Pricing, Books IBFD.



(2) **separate-entity accounts to test** the intra-group transactions on their meeting the requirements of the ALP under Article 9 of the OECD Model.

The new characteristics of the ALP under the post-BEPS framework are as follows:

- (1) contributions of each entity of a MNE group into **value creation and generation of profit**; and
- (2) **value chain analysis enabling the allocation of the intra-group profit within a MNE group**, where the separate entity approach is preserved but the outcomes of a single legal entity are analysed about the outcomes of an entire MNE). In a preserving the separate entity approach but analysing the outcomes of a single legal entity by its contribution to value creation vis-a-vis about the outcomes of an entire MNE.

*The principle of ALP has many critics. However, these critics had expected that the BEPS project would provide a chance for fundamental reform. Questions do arise as to - How do the BEPS TP actions direct the application of the TP rules in compliance with the ALP under the tax treaty provisions patterned after Article 9 of the OECD Model. On the other hand, supporters of the ALP contend that abandoning the principle would certainly increase occasions both of double and less than single taxation. The BEPS Project reiterated the significance of the ALP, but left room for a pragmatic bending of sorts, primarily through a less cautious use of the profit split method<sup>27</sup>. In the next section, discussion has been made on some of the criticism, strength and weakness of the ALP.*

## Section II: Criticism, strength and weakness of the arm's length principle

### 5. Criticism that exists for arm's length principle :

It is often criticized that ALP no longer fulfils the objective for which it was created i.e. allocation of taxing rights in a fair manner and hence the principle needs to be re-visited. The broad arguments that critics take in this regard are:

- **Reflecting the economic reality of the transaction :**
  - How adequately ALP reflects the economic reality, especially in the current economic environment (For example - In transactions involving intangibles which are becoming an ever-more dominant value driver for multinationals, and also the expanding domain of intangibles).
  - The principle does not take into account the economic interdependence between related entities.<sup>28</sup> It still sticks on separate legal entity concept, however, in today's world where transactions/ operations are so integrated, it is no longer feasible to rely on separate legal entity concept, in various situations. Paragraph 1.10 of the OECD TPG, 2017 also reflects that the ALP is considered by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses.

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<sup>27</sup> Alessandro Turina, Back to Grass Roots: The Arm's Length Standard, Comparability and Transparency – Some Perspectives from the Emerging World.

<sup>28</sup> Charles E McLure 'Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment' (2002), p. 586-587.

- **Consideration of demand-side factors:** Pertinent to mention, ALP which is based on FAR analysis considers only supply-side factors while demand-side factors (such as sales) are ignored. There is a need to move from FAR to a FARM approach that would add a market factor also to the FAR analysis. Thus, the market state shall also obtain the right to tax a certain part of the profit linked to sales in other state based on the nexus.

Pillar One approach of the OECD secretariat also resonates with the OECD's thoughts of markets contributing value to the MNEs value chain.

- **Harmonization issue<sup>29</sup>** : ALP's inclusion into domestic law or treaty law and the application of the OECD guidelines to the principle creates certain harmonization issues (for example : differences in the domestic tax system of the countries makes it difficult to harmonize the application of the ALP approach worldwide). Such issues can be categorized into the following situations:
  - Situations where there is provision both in domestic law and tax treaty that incorporate the arm's length principle, but they differ in wording and effect;
  - Situations where the domestic law provisions are themselves inconsistent with the arm's length principle. For example, if one were to take Indian example often it appears difficult to synchronize Section 92 of the Income tax Act which states the use of the ALP however rule 10 of the Income tax rules may not be consistent with ALP.

## 6. Strengths & Weakness of arm's length principle

### a. Strengths of the arm's length principle approach

- ALP is **objective and works in the different fact pattern because of its ability to adjust the return** (due to a single legal entity by reference to the facts and circumstances of the case) and in line with an economic indicator. It is very sound in theory and provides the closest approximation to the workings of open market forces
- **Stability and wide adoption of the ALP** - the principle is widely adopted and share several commonalities due to its development at the core of the OECD and the adoption of the countries taking as a starting point the MTC and the OECD TP Guidelines.
- **ALP provides broad parity of tax treatments for members of MNEs group and independent enterprises** - It, therefore, puts these enterprises on an equal footing for tax purposes and it avoids the creation of any arbitrage
- ALP is **intuitively straight forward in concept having historic existence and success**
- ALP is in accordance with the **principles of fairness and equity among taxpayers** - Another strength of the ALP concerns to its fairness and equity among taxpayers because it takes as a benchmark the market conditions to determine if the transactions carried out between associated enterprises are agreed upon similar conditions as the ones of independent entities. In doing this, the ALP constitutes an adequate tool for the materialization of the ability to pay principle equating the results obtained by MNEs to those of standalone companies.

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<sup>29</sup> Reference for this has been drawn from paper Duran Timms, 'The harmonisation of Transfer pricing : The obstacles , the arm's length principle and the OECD guidelines'.

**b. Weakness of the arm's length principle approach<sup>30</sup>**

Weaknesses concerning ALP can be categorized into the following categories:

<b>i. Conceptual Issues</b>	
a. Dealing with transactions that involve corporate synergies <sup>31</sup>	<p>Affiliated companies and independent companies are much different from each other. The reason is that MNEs may be created because they tend to generate greater returns by combining entities than can be obtained from separate market transactions. ALP does not consider these synergies effects of a group.</p> <p>As per the OECD TPG, taxpayers would have to document these anticipated synergies when applying the ALP. There are profits from synergies that are not captured in ALP based prices. Also, because of the synergy benefit, the economic situation of the MNE's may differ from the situation of potential comparable. Accordingly, appropriate adjustments may be required including the value of group synergies available to the tested party.</p>
Assignment of <b>business risks</b> and cost /benefits arising from the assumption of such risks	<p>Assumption of risk is an important step in ALP determination (OECD TPG, 2017 specifies the six-step process to analyzing risks), yet, it is difficult to isolate and clearly identify all risks.</p> <p>Further, in situations where risk is to be shared by different entities of the MNE group, it becomes difficult to identify reliable comparables or to make appropriate adjustments.</p>
Transactions involving <b>intangibles</b>	<p>Often difficulties arise in valuing intangibles, especially when it comes to hard to value intangibles, in such situation, the ALP seems to be an inapplicable approach.</p> <p>Further, most of them are unique intangibles/ intellectual property and it becomes difficult to find appropriate comparables, and as such, reliable comparables may not exist for some of them.</p>
<b>Dealing with capital</b> (flexibility with which capital can be transferred among the constituent entities of the group or calculation of correct returns for capital from related parties)	<p>Capital movements and the amount and mix of capital in individual members of the MNE group are certain areas which cannot be regulated by the ALP only.</p>

<sup>30</sup> Reference for this section is drawn from the book of Richard Collier and Joseph L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS (2017) Oxford University Press, Chapter 4.

<sup>31</sup> Reference has also been placed on OECD Transfer Pricing guidelines for Multinational enterprises and Tax Administration (2017), p. 89-91.

	<p>Issues are raised regarding the scope of Article 9 of the MTC and largely concerned with the thin capitalization/ interest limitation rules, which means profits otherwise accruing will not do so because of excessive quantum of interest payments. However, there remain several open questions some of which are extent to which Article 9 is relevant to capital? level and amount of capital? comparison to the treatment of capital under Article 7?</p>
<p><b>ii. Practical issues</b></p>	
<p>Availability of <b>adequate data regarding the operation of MNE</b> groups to capably administer an ALP based TP system</p>	<p>Access to information was considered as one of the most perceived shortcomings of the arm's length transfer pricing system. Due to the lack of information, it became difficult to :</p> <ul style="list-style-type: none"> <li>- Identify the nature of transactions or the actual terms and conditions</li> <li>- Functions and roles and assets (e.g. IP) and risks etc.</li> </ul> <p>However, attempts have been made to address this by action plan 13 (three tiered documentation regime) or strengthening country to country sharing of information under treaties. But, these documentation requirements raises a lot of compliance burden on MNE's and still, it cannot be determined to what extent this documentation shall be able to address the requirement of adequate availability of required data.</p>
<p>Availability of <b>adequate information about comparables</b></p>	<p>Finding the right comparable is one of the biggest challenges of the ALP approach. Though this has already been discussed in Comparability chapter upgrade in 2010, Toolkit on comparables by The platform for collaboration for tax, yet is still continues to be a challenging area.</p> <p>Difficulties arise in the following situation:</p> <ul style="list-style-type: none"> <li>- Lack of data on comparable transactions (especially in applying traditional TP methods)</li> <li>- Lack of public, local country data on independent company returns</li> <li>- Lack of comparable data for transactions involving intangibles</li> </ul> <p>Because of the lack of suitable comparables, the availability of market comparables to apply the traditional transactional methods (CUP, CP and RPM) has become scarce. Accordingly, states prefer to go for the two-sided approach like PSM over traditional transactional methodologies in certain situations.</p>

	The non-availability of data making the process too resource-intensive and time-consuming.
<b>Complexity in application</b> because of the structure of operations or for some other reasons	The factual analysis required in applying the ALP approach involves a lot of complexities (lots of information such as the nature of transactions, actual terms and conditions, functions, roles, assets, and risks are needed), these challenges are exacerbated by the complexity of global supply chains and numerous cross-border transactions in components and services involved in bringing a product to market. Further, it is difficult to concretely conclude that any point of difference between a transaction involving associated enterprise and a comparable transaction between independent enterprises is not important or relevant to the analysis.
<b>The high degree of discretion</b> in the application of ALP	As transfer pricing is not an exact science, so it becomes difficult to have complete precision in applying ALP. It is difficult to identify the real-world situations where the relevant facts are well known, where clear information are available and often discretion needs to be applied while applying ALP.
<b>iii. Interpretational<sup>32</sup> issues</b>	
<b>Reconciliation in the dual role of Article 9</b> and the transfer pricing rules (ensuring the elimination of double taxation and as an anti-abuse measure), is it possible	<p>Because of the differing nature of how ALP is incorporated in domestic tax laws, it becomes difficult to reconcile the dual role of Article 9.</p> <p>A different method of transfer pricing calculate ALP differently - The profit-split approach, , applied in case entities make non-routine contributions, jointly contribute to risks or perform integrated activities, 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 transaction as a whole. The net margin method (or comparable profits method, as it is referred to in the US) 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.</p>

<sup>32</sup> These are issues that pre-existed before BEPS but maybe it has got accentuated due to post-BEPS effects.

<b>Scope of Article 9</b> of the OECD MC	There are often issues relating to the territorial scope of Article 9. Also, there has been a lot of discussion on the issue of whether Article 9(1) is illustrative or restrictive in nature (Discussed earlier in Section I).
<b>Lack of uniform definition</b>	<p>For Article 9, there is no express global definition of the ALP nor is it applied uniformly. Further, another element of Article 9, namely the concept of AE is not expressly defined in the MTC. The fact is that the precise meaning to be given to this concept either by domestic rules or many times as a result of the interpretative work provided by the courts.</p> <p>Furthermore, commentary on Article 9 of the OECD Model is very brief, consisting of only 5 pages, and is not helpful in the interpretation of the arm's length principle.</p> <p>A question arises - Can a uniform interpretation of the ALP at the level of tax treaties may be found by means of an expanded Commentary on Article 9 of the OECD MTC?</p>
<b>Changes to OECD Model Convention commentary</b> to be applied prospectively or retrospectively	OECD always advocates the use of the latest version (i.e. ambulatory approach) of the commentaries. However, distinction in this regard should be placed on the clarificatory changes to the commentary and changes which are material and substantive changes. Yet, the problem persists in this area when it comes to practical application because of the differing views.

### ***Dissatisfaction with the arm's length principle***

The aforementioned weakness have led to many expressions of dissatisfaction with the ALP. In a market of imperfect competition, it's difficult to find ALP at a single point. Even in perfect competition<sup>33</sup>, there would exist differences in which ALP should be understood and the manner in which it is laid down in the TPG guidelines.

The new world of Digitalisation and Datazitation brings a lot of new developments and innovative ways of doing business. These developments put more pressure on the concept and operation of the ALP; as has already been highlighted from the entire debate of ALP and the unified approach.

Further, relying only on ALP will not work in data economy where allocation should not be only restricted to source and residence country but to all the countries whose actors take part in the data value chain.

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<sup>33</sup> For example - The concept of normal profit compare the level of profit to capital investment. The similar ROI between the two comparable transactions does not imply that the ratio of profit to sales or another flow concept will also be similar. (Like TNMM has to be applied relative to a comparable base, and for that the filters and comparability analysis has to be carried out and RoI in an automobile company cannot be compared with RoI in a power company, even if the return on sales is the same, because of industry differences).

## Section III – Mechanism to address identified in Section II above<sup>34</sup>

### 7. Mechanism of addressing some of the weaknesses identified<sup>35</sup>

#### a) Potential ways to simplify the usage of the existing ALP approach :

##### - Increased usage of safe harbour rules

In a broad range of circumstances, especially those involving low value-adding services, (low-risk distributor arrangements and contract manufacturing service arrangements), safe harbours have the potential of significantly easing compliance burdens (A typical example here could be of Brazilian TP system). Even OECD guidelines acknowledge the use of safe harbours for Low value-added intra-group transactions. Bilateral safe harbours can be a good option, a proxy for BAPAs.

##### - More reliance on profit split methods

With the advancements in business models and more increased integration of various transactions/ operations, reliance on profit split method ('PSM') becomes implied as it becomes difficult to find comparables. Also, PSM being a two-sided method; removes the critics that are associated with using the one-sided method.

#### b) Situation/ transaction specific scenarios :

##### - Intellectual Property

The main problem here is the development and transfer of intangibles to other group entities for less than full value without shared participation in group economic benefit. Though action plan 8-10 has brought clarity concerning intangibles, yet valuations and compensation are certain areas where the conflict will continue. Hence, further guidance and more work need to be carried out in this area.

##### - Capital

The main problem here is overcapitalization of certain entities in the group. This may involve the adoption of a measure intended to address overcapitalization (thick capitalization approach), excess return approach (which are designed to ensure appropriate taxation of excess return by using primary and secondary rule) etc. to address the problem situated with the intra-group transfer of capital. Also, there is a need for more practical experience emanating from the implementation of new Chapter X of the OECD TPG that deals with loans and guarantees.

##### - Funding

The main problem here is an excessive deduction on account of interest payments to group entities. One of the chief early concerns in the BEPS project was the use of excessive interest deductions to related part. It is to be seen whether the measure suggested by OECD in Action plan 4 or the fixed ratio approach can cover those situations. However, some academics are of the view that a fixed ratio

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<sup>34</sup> Apart from others, reference for this section has also been drawn from Reference for this section is drawn from the book of Richard Collier and Joseph L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS (2017) Oxford University Press, Chapter 8

<sup>35</sup> Ibid (n 34).

approach/ interest limitation deduction with or without group ratio rules may not be able to address all situations. Hence, more work needs to be carried out in this area. Related to capital and funding is the matter of debt equity ratio, since in a debt transaction, there are three levers – the debt:equity, the interest cover and the arm’s length price of the debt, all of which have to pass muster under ALP.

- **Risks**

The main problem here is the contractual allocations of risk to entities in low-tax jurisdictions in transactions that are unlikely to occur between unrelated parties. A good fit with economic reality would be provided by an approach that gives more specific recognition to group-wide risk sharing. In such cases, proper care may be taking care of risk premium and the assertion of transfer of risk premium to low-tax jurisdictions will not hold good.

**c) Alternative to ALP**

It is important that if any alternative measures are adopted, such measures should be perceived as fair by all the jurisdictions to have the chance to reach an agreement. There has been a lot of discussion on the alternative approaches that can be used as a replacement for ALP in academia. The unified approach proposed by the OECD secretariat is one such attempt which covers specified categories of businesses. Some of the other alternatives discussed for ALP are :

<b>Approach</b>	<b>Description</b>
<b>Destination based cash flow system<sup>36</sup></b>	This approach aims to be a tax on net cash flows and is intended to apply only to corporations. The destination based cash flow system involves replacing the current income-based taxation with consumption type tax system, however, this is not that tax should be levied in place of consumption per se but rather than the relevant tax should be applied by reference to a place of relative immobility.
<b>Residual profit Allocation of income<sup>37</sup></b>	This approach allocates taxing rights of routine profits to countries in which functions and activities take place (as done in the current system). It then allocates the right to tax residual profit to the market, or destination, the country where sales are made to third parties. In a way, this approach uses existing principles to achieve what they are generally thought to achieve i.e. to calculate and allocate routine profits, and it reaps the benefits of a unitary approach where they do not (in allocating the residual profit).

<sup>36</sup> Michael P Devereux and others, 'Residual Profit Allocation by Income', Michael P Devereux and others, 'Residual Profit Allocation by Income', Oxford Legal Studies Research Paper No. 17/ 01.

<sup>37</sup> Michael P Devereux and others, 'Residual Profit Allocation by Income', Oxford Legal Studies Research Paper No. 41/2019.



<p><b>Formulary &amp; transaction based profit split method<sup>38</sup></b></p>	<p>The use of formula-based or standardized transaction-based PSM leads to lesser intervention in the sovereignty of the countries. This approach is based on both the sales-oriented and sales-based PSM (the simplified approach of the PSM). Steps that are followed for this approach would mainly involve:</p> <ul style="list-style-type: none"> <li>- Determination of the total profit gained from a transaction</li> <li>- Differentiation between a profit situation and a loss situation regarding the transaction. If profitability is positive, the routine functions involved in the value-chain process, are to be remunerated with a fixed mark-up on costs (expenses) like the remuneration of low-value adding services</li> <li>- Remuneration is calculated based on incurred costs for functions performed and risks assumed of the service-providing companies which are involved in the value-chain process and are provided other than only routine functions</li> <li>- Remaining profit (or loss) is then allocated to the sales-oriented companies</li> </ul>
<p><b>Formulary apportionment</b></p>	<p>Under this method, the global consolidated profit of the MNE group is apportioned among the individual group companies in different jurisdictions basis the predetermined formula (typically suggested formula is a combination of an asset, payroll, sales).</p> <p>However, results produced under this approach and the ALP may differ greatly from one another because the basis of sharing the profits within an MNE differ greatly between these two methods. Even the European Common Consolidated Corporate Tax Base ('CCCTB') highlights the use of unitary approach i.e. fractional apportionment approach. India's approach of fractional apportionment in the draft report for amendment of rules for profit attribution to PE issued last year is an example for a move towards formulary apportionment.</p> <p>Though, formulary apportionment method can be a simpler approach, but it would work well only when there is a global agreement on use of such approach.</p>

<sup>38</sup> Stefan Greil, 'The Dealing at Arm ' s Length Fallacy : A Way Forward to a Formula-Based Transactional Profit Split ?' (2017) Intertax, Volume 45, Issue 10 p. 624.

<b>Minimum Income system</b>	This would operate by imputing income to individual corporations within an MNE group based on a specific percentage of the adjusted book value of the corporation's assets. The purpose of this approach would be to ensure that all profitable entities pay some taxes.
<b>Dual method</b>	These would entail use ALP for supply side and formulary for demand/ market side. An example that combines the old system (ALP) with a new one is the proposal found under the Pillar One of the OECD, according to which the residual profits of the MNEs should be allocable in the jurisdictions where the group has an economic presence (sales or consumers) based on the formulaic approach.
<b>Hybrid method</b>	This method combines both fixed return approach and formula-based allocation to allocate the residual profits.

## 8. Benchmark on which ALP or any allocation methodology may be measured<sup>39</sup> –

Despite the extensive regulatory framework, however, the bottom line of applying the ALP is the following;

'[...] transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer'<sup>40</sup>

However, the following are certain parameters on which any allocation methodology may be measured -

- The measure must **reflect economic reality**
- Regulation should be **upto the date and able to capture progress**
- **Administration/ enforcement cost** should be minimized
- **Fair allocation of tax** in the jurisdiction
- Should be **implemented in corporate tax law in a pragmatic manner**

<sup>39</sup> Jelle Pleune (n 16), p. 24-25.

<sup>40</sup> OECD Transfer Pricing guidelines for Multinational enterprises and Tax Administration (2017), para 1.13.

## Section IV: Alignment of arm's length principle with value creation and linking arm's length principle with holistic value chain

### 9. Alignment of arm's length principle with value creation

With action plan 8-10<sup>41</sup> it seems that a new standard to allocate profits from transactions based value-creation principle vis-a-vis functions performed rather than finding comparable transactions based on ALP seems to have been laid down. However, BEPS project actions 8-10 also reaffirms that ALP is the conceptual core of global transfer pricing principles, as ALP has proven over time to be the acceptable way of reaching an agreement for allocation of taxable income among group entities operating in different states.

The purpose of value creation is to find the true nature of the actual controlled transaction while ALP refers to what the unrelated parties would have done in comparable circumstances. Thus, it is difficult to reconcile both concepts. Value creation, unlike the ALP, leaves no room for any hypothetical transaction. On the contrary, it may be said that value creation is a way to predefine the transfer pricing rules, or possibly more accurately, to predefine the method as a method based on functions performed, the capacity to perform those functions and the market for the product or service. It rather reflects the profit allocation character of the ALP.

In all, the following question arises:

- (i) Whether the **alignment of TP rules with value creation will lead to the allocation of profits in accordance with the ALP?**
- (ii) **Is value creation representative of remote economic activity, i.e. does it capture the effect of activities arising from external actors in the value chain that are then resulting in profits in the MNE group?**

### 10. Linking arm's length principle with holistic value chain

Post-BEPS transfer pricing may be understood as a practical attempt to adapt the ALP to the realities of the intercompany relationships of an MNE and its alignment more with the value creation and value chain.

The functional analysis determines the FAR carried out by the MNE in the controlled transaction while value chain analysis focuses more on determining how value is created, how different business activities interact with each other, how profits are allocated amongst entities in global value chain etc. Hence, the value chain analysis considers a holistic approach and looks at all the value drivers and critical success factors for the MNE as a whole. However, not all methods of transfer pricing consider the value chain analysis completely in the determination of ALP.

(For example – TNMM focuses on FAR analysis and it may be not to correct to say that FAR<sup>42</sup> analysis in all situation reflects the complete value chain).

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<sup>41</sup> OECD, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project (2015).

<sup>42</sup> FAR analysis is qua the participant to the transaction, and not the group as a whole. So it does not reflect the value chain.

Hence, certain questions that may arise are - how can we match the holistic value chain with ALP? One such example can be from the side of TP documentation where MNEs need to have complete FAR and value chain analysis in place to determine the value created/ activities performed by a different entity in the group. Synchronization between the allocation of profits to different entities in the group can be made from a holistic perspective by using a VCA<sup>43</sup> ( Also, the comparability analysis may supplement the VCA, as based on the VCA, determination of characterization and economic analysis can be made). This further help in determining that whether the allocation done to various entities in the group matches with holistic VCA<sup>44</sup>.

## Section V: Outlook and conclusion

### 11. Conclusion and open questions

The 2017 OECD TOG point out that the ALP is so well-entrenched as a substantial body of common understanding among taxpayers, tax administrators, and courts that abandoning it could lead to the same harm digital tax proposals are meant to avoid — that is, unfettered unilateral action and a breakdown of international consensus. A move away from the ALP would abandon the sound theoretical basis described above and threaten the international consensus, thereby substantially increasing the risk of double taxation. However, this principle might have been appropriate in the 1920s but in the current age of advancements in technologies and new ways of doing operations (such as innovations in IT, transportation and communication) which revolutionize MNE business models and lead to even closer and more integrated MNEs, ALP may not work in all situations. Some of the open questions in this regard, the answer of which may help in finding a some solution to are:

- *Could the ALP be applied and/or adapted to appropriately achieve the **desired redistribution of profit throughout the value chain by modifying the current Transfer Pricing Guidelines***
- *Does the ALP continue to constitute the method most suitable for being utilized as the paradigm for international taxation? If not, what reforms ALP need? For example - if **ALP remains as an international tax system; along with other upcoming allocation techniques (like unified approach), what modification is required?***
- *Is **broadening of current OECD ALP principles – an alternative?** Or is a **combination of Formulary and ALP is a way out?***
- *Should **group dimension be recognized** – i.e. a mechanism to enforce group interest and increase legal certainty in transfer pricing?*
- *Can **administrative interactions and interventions such as BAPAs establish transfer prices?***
- *Is enforcing **Transactional Adjustments<sup>45</sup> in accordance with the ALP a solution<sup>46</sup>**? In situations in which (i) no comparable transactions exist; (ii) comparability adjustments cannot be made; and (iii) the application of a hypothetical arm's length test is not suitable, the only option for complying with the consequence provided by transfer pricing rules based on the arm's length principle is the*

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<sup>43</sup> 'An understanding of the MNE's full value chain is at the heart of the newly developed BEPS framework such that the value chain of the consolidated taxpayer is considered in assignments of profitability (and associated transfer prices) to individual entities' (<https://www.pwc.com/gx/en/tax/publications/transfer-pricing/perspectives/assets/tp-16-value-chain-analysis.pdf> accessed on 27 October 2020).

<sup>44</sup> A corroboration of quantitative VCA with qualitative VCA would help to determine the accuracy of the result.

<sup>45</sup> There are situations in which transactional adjustments do exist, namely hard-to-value intangibles, business restructurings and cost contribution arrangements etc. However, those have been criticized on several grounds.

<sup>46</sup> Aitor Navarro, Conclusions in Transactional Adjustments in Transfer Pricing (IBFD 2018), Books IBFD

*enforcement of transactional adjustments, i.e. the proposal of alternatives to the transaction as structured by related parties. If yes, what alternative proposals can be drawn for transactional adjustments?*

However, any consensus solution must also reflect the right balance between precision and administrability for jurisdictions at different levels of development, reinforced by sound economic principles and conceptual bases and ensure a level playing field among all jurisdictions.

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