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Marta Pankiv

Contemporary Application of the Arm's Length Principle in Transfer Pricing

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Contemporary Application of the Arm’s Length Principle in Transfer Pricing

Why this book?
This book outlines how the application of the arm’s length principle should be reconsidered in light of the initiative of the OECD and G20 to counter tax base erosion and profit shifting (BEPS). The arm’s length principle embedded in article 9 of the OECD Model is not an anti-avoidance rule and has been misidentified as the primary tool for tackling abusive practices. Transfer pricing analysis, commonly understood as examining economic substance, in reality examines whether related parties have the functional and financial capacity to perform the contracts they have entered into.

The notions of ownership, substance and commercial rationality are identified as controlling criteria for compliance with the arm’s length principle, which has its origin in contract law. This conclusion is reinforced with analysis of international court cases. Common intercompany arrangements of IP holding, cash pooling and debt factoring further suggest that the starting point of any transfer pricing analysis should be the identification of the mandatory terms of intercompany contracts. A template for contract analytics is therefore also provided.

The framework for contemporary transfer pricing analysis that is developed defines the boundaries of the arm’s length principle, with the objective of eliminating economic double taxation and neutralizing the effect of corporate income taxation on foreign direct investment. This book is unique in that it takes a legal approach to transfer pricing in the context of tax law. It can be consulted by transfer pricing practitioners, tax officials and academics alike in countries where the arm’s length principle based on article 9 of the OECD Model is endorsed in domestic law.

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Foreword

Transfer pricing seems to be laden with methodological complexity and a persistent mythology that goes along with it. Its importance in "international taxation" has been magnified by the attention devoted to it by the Organisation for Economic Co-operation and Development (OECD) and the G20 in their BEPS (base erosion and profit shifting) project, identifying it as both a device to achieve and a measure of "base erosion and profit shifting". The United Nations, the International Monetary Fund and the World Bank, separately but also together with the OECD as members of the "Collaborative Platform", are focused on the significance and analytical underpinnings of transfer pricing as an influence on global economic order.

At its core, however, "transfer pricing" is not intrinsically methodological or mechanical, even though it makes use of a variety of analytical devices that help to identify the organizational features of taxpayers and their transactions as members of closely held corporate families. It is more fundamental. Essentially, it is concerned with detecting and adjusting for circumstances in which the lack of adversity in dealings within a commonly controlled corporate group can foster distortions in international income allocation attributable only to internal corporate decisions and the exercise of control, and not to commercial arrangements consistent with how unconnected parties would deal in their own interests. Hence, the "arm's length principle" (or, commonly, "standard") is the notion, or rubric, used to describe analysis designed to detect and deter the exercise of control for its own sake to direct income away from those who actually contribute meaningfully to earning it within the corporate family.

Dr Marta Pankiv's book takes us back to this origin and purpose of the "arm's length principle" as a device to test and adjust the allocation of "profits". Article 9 of the OECD Model Tax Convention and its analogue in the United Nations Model Tax Convention do not speak of "transactions", "costs", "revenue", the "right" price, "fair market value", or any analytical methodologies – one might say, analytical wizardry. That article, more accurately, addresses "conditions" with respect to "commercial or financial relations" among "associated" parties that have the effect of distorting – misallocating – "profits". It is about allocating profits within a commonly controlled group, and only in that respect is the manner in which the group functions relevant. It is about distortions that can be associated fairly with an opportunistic, uncommercial, even unlimited exercise of "control" or "power" within a corporate group to determine outcomes for that reason alone. Equally, it concerns the alignment between the organizational and commercial dealings within a corporate group with profit outcomes. I like to describe "transfer pricing" as the "box" within which outcomes arising from the application of all the more "technical" tax rules are collected and kept.

This is important to remember. The OECD and the G20 have remembered it; it is a persistent and forceful theme underlying their commentary on Actions 8 through 10.

Dr Pankiv forcefully remembers it too. Her book is a testament to that. She reminds us how and why the arm's length principle originated. She reminds us of what transfer pricing is meant to achieve. And, she takes us beyond the theory of transfer pricing and its all too common methodological mantra to illustrate her exposition of the arm's length principle as a practical directional principle, using examples that are common in typical business settings. Persuasively, with the benefit of its history, she helps us to understand the arm's length principle not as an anti-avoidance rule as such, but as the essence of the objectives of international taxation to align the measurement of profits with how profits originate – how they are earned – and, in other words, their source. In so doing, Dr Pankiv enriches our store of interpretative tools in transfer pricing, facilitating their more informed, reliable and predictable application.

I would also like to offer a personal reflection. I had the great good fortune to assist Dr Pankiv as a supervisor of her doctoral work – her dissertation – leading to this book and, in the course of that engagement, to come to know her as a friend. I admire her persistence, her unwavering commitment to her subject, and her overarching concern to understand – really understand – transfer pricing and its larger tax and legal context. These qualities, which sparkled during her academic endeavours even when the challenges of doctoral studies seemed forbidding, contributed to insights in her work that enriched my own understanding of this subject, for which I am doubly grateful. I would like to congratulate Marta and commend her work for your study and reflection, with the hope and wish that you will benefit from engaging with Marta as much as I have.

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Preface

This book examines the arm's length principle as a legal norm of international tax law that establishes the boundaries for domestic tax law in order to secure legal certainty. It is based on a dissertation submitted in fulfilment of the requirements for the PhD degree at Vienna University of Economics and Business in September 2016, and is updated with recommendations on how the application of the arm's length principle in transfer pricing should be reconsidered in view of the OECD and G20 initiative to counter tax base erosion and profit shifting (BEPS).

It is argued in this book that the arm's length principle, as embedded in Article 9 of the OECD Model, is not an anti-avoidance rule and has been misidentified as the primary tool to tackle certain abusive behaviours of multinational groups. As such, transfer pricing analysis as commonly understood to involve an examination of "economic substance", i.e. determination of the critical elements of related-party dealings, essentially examines whether the parties have the functional and financial capacity to perform the contracts they have concluded, either in a written form (explicit contract) or orally (implicit contract).

Based on the analysis of international court practice, the notions of "ownership", "substance" and "commercial rationality" introduced by the OECD in the BEPS project are recognized as decisive for compliance with the arm's length principle, which has its origins in contract law and aims to arrange an equitable agreement that will stand up to legal scrutiny. The research undertaken regarding particular but common types of intercompany transactions (i.e. IP holdings, cash pooling and debt factoring arrangements) extracts the elements of the arm's length principle that can be applied to guide any transfer pricing analysis.

In particular, the "conditions made or imposed between the two enterprises in their commercial or financial relations" under Article 9 of the OECD Model are considered to be the starting point for transfer pricing analysis to define the mandatory terms of intercompany contracts based on the controlling criteria of ownership, substance and commercial rationality. Such a three-concept test is presented using the template of intercompany contract analytics, which is helpful to apply in the course of a functional and risk analysis.

In order to avoid uncertainty for both taxpayers and tax authorities in the application of the transfer pricing rules based on the arm's length principle, due to a potentially wrong interpretation of the latter, especially post-BEPS, this book proposes to define the key characteristics of the arm's length principle as a norm of international tax law in line with the Commentary on Article 9 of the OECD Model. Further to the anti-BEPS recommendations of the OECD, the Commentary is suggested to serve as a framework for the proper application of the arm's length principle in transfer pricing analysis.

This book presents interdisciplinary research in law and business intended to achieve a more coherent application of the arm's length principle in the cross-border allocation of business profits. It will therefore be of interest and practical relevance to transfer pricing practitioners, tax officials and academics.

Sample Chapter

Introduction

1.1. Background

This book will consider the arm's length principle and its contemporary application in transfer pricing practice from a tax law perspective. The objective is to examine the arm's length principle as a legal norm of international tax law. It establishes boundaries for domestic law to eliminate economic double taxation in the cross-border allocation of business profits of multinational enterprises (MNEs), which currently account for over 70% of global trade.

The study sets out to establish an analytical framework for transfer pricing analysis. The arm's length principle may function as an authoritative test for the compliance of domestic law's transfer pricing provisions with double taxation treaty provisions patterned after article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital (OECD Model).[1] A more coherent application of the arm's length principle as an international norm should enable the allocation of MNE profits in a way that neutralizes the effect of corporate income tax on their foreign direct investment (FDI), thus promoting the trade and welfare of nations engaged in international trade.[2]

The interdisciplinary aspect of this study lies therein that it applies legal analysis based on "the arm's length principle" (of which article 9 of the OECD Model is the authoritative statement) to a business concept of

1. OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2014* (Paris: OECD, 2014), available at: http://dx.doi.org/10.1787/mtc_cond-2014-en.
2. *See* Desai & Dharmapala, *An Alternative Transfer Pricing Norm*, Unpublished Working Paper (2011), p. 5, available at: http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Events/conferences/symposia/2011/dharmapala.pdf. ("Multinational firms are defined as firms that originate in one country (the 'home' country) and subsequently begin operating in multiple other nation states (the 'host' countries). Their home country operations are usually labeled as the 'parent' company while their operations around the world are usually labeled their 'foreign subsidiaries'. From a more aggregate perspective, the foreign subsidiaries of multinational firms represent 'outbound foreign direct investment (FDI)' to the home country and 'inbound FDI' to the host countries. Measurement of FDI typically consists of measuring its annual flow or its cumulative stock, often relative to Gross Domestic Product (GDP) or a measure of investment such as Gross Fixed Capital Formation (GFCF).")

"transfer pricing". The base erosion and profit shifting (BEPS) project of the OECD/G20[3] identified the misreporting of taxable profits resulting from the misapplication of the arm's length principle. Such misapplication was to have occurred in the following areas of MNE business activities:
(i) development and transfer of intangibles for less than full value and without shared participation in group economic benefit;
(ii) over-capitalization of low-taxed group entities, particularly in reliance on capital supplied directly or indirectly by high-taxed group entities; and
(iii) contractual allocations of risk to entities in low-tax jurisdictions in transactions that are unlikely to occur between unrelated parties.

The misapplication of the arm's length principle constitutes a "gap" between the principle and its proper interpretation and subsequent application in practice. The focus of the study conducted in this book will be to analyse the "gap" areas as they are defined in the BEPS report[4] of the OECD in the context of the arm's length principle under article 9 of the OECD Model. The particular areas addressed are as follows:
(i) intangibles, contribution to their development and deployment, and entitlement to a return;
(ii) contractual allocation of risks and capital and what it means to bear risk; and
(iii) non-recognition of transactions.

The misapplication of the arm's length principle (as identified by the BEPS project in the above-mentioned areas) is the result of an erroneous interpretation of the principle, mainly in the following two respects:

(1) The arm's length principle cannot be regarded as an anti-avoidance measure to combat the abusive practices of MNEs under tax treaties. Anti-abuse measures are the prerogative of domestic law based on the substance-over-form doctrine and are applicable unilaterally, whereas the arm's length principle is a bilateral concept that is aimed at the appropriate allocation of profits between source and residence countries.

3. OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at: http://dx.doi.org/10.1787/9789264192744-en; OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at: http://dx.doi.org/10.1787/9789264202719-en.
4. OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD, 2015), available at: http://dx.doi.org/10.1787/9789264241244-en (OECD/G20, BEPS Final Report on Actions 8-10).

Accordingly, the arm's length principle cannot be used to tackle abusive practices.

(2) The arm's length principle is a general principle of tax treaties. The interpretation of the arm's length principle should not be limited to the methodological guidance of the OECD, summarized in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).[5] Instead, the interpretation of the arm's length principle should be based on the general principles of interpretation laid down in the Vienna Convention on the Law of Treaties.

As a matter of tax treaty interpretation, the arm's length principle authorizes the tax authorities of a contracting state to rewrite the accounts of a group entity by making a transfer pricing (primary) adjustment, to ensure that the true profits are taxed in that state under article 9(1) of the OECD Model. To meet its objective of mitigating economic double taxation, the arm's length principle also authorizes the tax authorities of the contracting state to make a corresponding adjustment under article 9(2) of the OECD Model. These adjustments are regarded as profit adjustments and should not be confused with mere *price* adjustments. Furthermore, such profit adjustments should not be confused with *transactional* adjustments.

With respect to pricing adjustments, the price of an item cannot serve as the only proxy of the profits of the whole group. Therefore, the methodological guidance of the OECD Guidelines focused on finding comparable prices cannot be the *only* source for assessing the arm's length nature of related-party arrangements. With respect to *transactional* adjustments, a transaction as it is structured between two related parties should be respected and may only be formally disregarded pursuant to a substance-over-form determination under domestic law. If this is the case, and a transaction is disregarded in one contracting state, neither that state nor the other contracting state may apply the arm's length principle under article 9 of the OECD Model. In such a situation, the issue of double taxation should then be resolved under other treaty provisions.

This study takes a legal approach to transfer pricing in the context of tax law. The following issues are addressed: (i) What are the key characteristics of the arm's length principle as a norm of international tax law codified

5. OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010* (Paris: OECD, 2010), available at: http://dx.doi.org/10.1787/tpg-2010-en.

in article 9 of the OECD Model? (ii) How do BEPS transfer pricing actions direct the application of transfer pricing rules, in compliance with the arm's length principle, under tax treaty provisions patterned after article 9 of the OECD Model?

The BEPS project identified "gap" areas relating to the application of the arm's length principle. Such analysis is tested in this book by analysing international case law in the context of typical business arrangements in an intra-group setting, exemplified by the following:
(i) IP company structure (which is analysed based on the *concept of legal and economic ownership*);
(ii) cash pooling (which is analysed based on the *concept of economic substance*); and
(iii) debt factoring (which is analysed based on the *concept of commercial rationality*).

The case law approach is premised on the principle of "common interpretation" where it is reasonable to expect that the courts of different jurisdictions strive to interpret treaty provisions consistently. The OECD Model is considered to be a foundation for such "common interpretation" of particular provisions. The examples provided above of (i) an IP company structure; (ii) cash pooling; and (iii) debt factoring help to generalize the analysis to a broad spectrum of firms engaged in international trade, so that it is not limited to specific industries.

As part of the analysis, historical and analytical perspectives on the development of the arm's length principle are also developed in detail. From a historical perspective, the evolution of the arm's length concept is reviewed in order to establish whether the arm's length principle has remained faithful to its original intent. From an analytical perspective, various policies are discussed that should underlie the arm's length principle to meet its own objective as a norm of international tax law.

The OECD Model and its Commentary serve as a basis for the majority of bilateral tax conventions. The usage of the arm's length principle within the model tax conventions, in particular the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model),[6] is essentially identical to the OECD Model and, therefore, only

6. UN, *Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2013), available at: http://dx.doi.org/10.18356/a545408b-en.

the latter is referenced. The arm's length principle is also examined solely in the context of corporate income tax. Finally, the analysis reflects the perspective of double tax treaties and not the domestic law of any particular country.

1.2. Contents

This book consists of an introduction, conclusion, and four main chapters that are structured as follows:

Chapter 2: "Approaches to cross-border allocation of profits" describes the available approaches to the cross-border allocation of profits in an intra-group setting, i.e. arm's length principle and formulary apportionment, and provides an overview of their key features as a background for the analysis of the transfer pricing provisions in the subsequent chapters.

Chapter 3: "Application of arm's length principle" explains the existing practice of the application of the arm's length principle.

Chapter 4: "'Misapplication' of arm's length principle" provides an overview of the subject matters identified by this study under BEPS transfer pricing actions and provides an analysis of the court practice in the relevant areas.

Chapter 5: "New framework for transfer pricing analysis" provides a framework for the contemporary (post-BEPS) application of the arm's length principle based on the research in the preceding chapters.

Notes

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