EDITORIAL

Profit Splitting and the Aspirational Arm's Length Standard

1 Introduction

The future of the international tax system is being debated in international fora, including the issue as to whether the current system based on transfer pricing and the arm's length standard applicable to controlled transactions, should be replaced by a profit split method. At the core of the discussion is the (in)adequacy of the arm's length standard, which is mainly or almost exclusively based on comparable transactions among unrelated parties, in cases where comparable transactions do not exist, in order to achieve an arm's length result.

The arm's length result would assure parity in taxation of controlled and uncontrolled transactions and corresponding taxpayers, and a fair allocation of taxing rights between the jurisdictions involved, as long as there are comparable transactions. From a traditional perspective, in the absence of the comparable transactions, national tax authorities would not be allowed to challenge the allocation of income and costs among the related parties, as determined by the taxpayers. This would be so, at least in light of their tax treaty obligations, and even if the interplay of cost and income allocation between a parent company in a high-tax jurisdiction and a subsidiary in a low-tax jurisdiction result in a significantly reduced tax liability for the parent.

2 *Altera Corporation v. Commissioner of Internal Revenue*

The *Altera Corporation v. Commissioner of Internal Revenue* (*Altera Corp.*) case, decided by the US Court of Appeals for the Ninth Circuit on 24 July 2018,[1] – but subsequently withdrawn, and currently pending[2] – illustrates how the traditional arm's length analysis based on comparable transactions among unrelated parties, to achieve an arm's length result, has been challenged by the US Congress and the US Treasury. This is a result of the fact that many transactions between related parties do not find equivalents among unrelated parties.

The *Altera Corp.* case involved employee stock options (stock compensation), in a research and development (R&D) cost-sharing agreement, between Altera Company in the United States and one of its subsidiaries, Altera international Inc., a Cayman Islands corporation. Amendments to Treasury regulations in 2003 expressly classified stock compensation as a cost to be allocated between qualified cost-sharing arrangements (QCSA) participants. Such arrangements are meant to avoid adjustments by the Treasury. Those amendments to Treasury regulations also clarified Treasury's understanding that the cost sharing regulations operate to produce an arm's length result.[3]

At the outset, Altera Company and Altera international Inc. agreed to pool their resources to share R&D costs, including the share of employee stock compensation, in proportion to the benefits anticipated, as a result of 2003 amendments to Treasury regulations. However, the two parties later suspended the share of employee stock compensation in R&D costs (for the 2004–2007 federal income tax returns). One of the arguments asserted by the taxpayer regarding this suspension, is that sharing of such compensation costs would be contrary to the arm's length standard (i.e. based on comparable transactions between unrelated parties).[4]

The US Treasury regulations, allocating the costs of employee stock compensation between related parties, are based on a legislative grant of authority (26 US Code section 482, as amended in 1986) to the Treasury, to

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1 US: CA 9th Cir., 24 July 2018, *Altera Corporation & Subsidiaries v. Commissioner of Internal Revenue*, No. 16-70496 (9th Cir. 2018). The case was decided by majority opinion, with one dissenting vote, and later withdrawn.

2 Judge Stephen Reinhardt, one of the judges who voted to uphold the regulations' validity died before the opinion was issued on 24 July, and on 2 Aug., Judge Susan Graber was appointed to replace judge Reinhardt. On 7 Aug. the order was withdrawn 'to allow time for the reconstituted panel to confer on the appeal', http://cdn.ca9.uscourts.gov/datastore/opinions/2018/08/07/16-70496.pdf (21 Aug. 2018).

3 *Altera Corp. v. Commissioner*, at 23.

4 *Altera Corp. v. Commissioner*, at 9, following the Tax Court's opinion in *Xilinx, Inc. v. Commissioner*, 125 TC 37 (2005). *See* the criticism on Xilinx, by Y. Brauner, Cost Sharing, and the Acrobatics of Arm' s Length Taxation, 38 (11) Intertax 554–567 (2010).

allocate income between related parties, if the Treasury determines 'that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly reflect the income of any such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property … , the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible'.[5]

It seems clear from the legislative history of the Tax Reform Act of 1986 that a QCSA would achieve an arm's length result if it reflected all relevant costs, including 'the cost of compensating employees for providing services related to the development of the intangibles pursuant to the QSCA'.[6]

The issue in *Altera Corp.* is whether the US Treasury may validly allocate between related parties a cost that unrelated parties do not share. In favour of the validity of such allocation, the main rationale of the withdrawn decision by the US Court of Appeals in *Altera Corp.* was that the arm's length standard is results-oriented, meaning that its goal is parity in taxable income, rather than parity in the method of allocation.[7] Congress granted flexibility to the Treasury, so that the division of income between related parties must reasonably reflect the relative economic activity undertaken by each party.[8]

3 The Meaning and Purpose of the Arm's Length Standard in the United States

Independently of the final decision in *Altera Corp.*, the pending case also illustrates how the US international tax system is possibly moving towards profit splitting, as a development of the arm's length standard, with no need to replace this standard. Additionally, whatever the outcome of *Altera Corp.*, US law has been flexible by expressly referring to the arm's length standard as a tool to prevent tax evasion, and to clearly reflect the income of any of the related parties.

In fact, the first paragraph of the Revenue Act of 1928, Chapter 852, paras 45, 45 Stat. 791, 806 (1928), and which has remained substantively unchanged since then, refers to the competence of the Treasury to 'distribute, apportion or allocate gross income, deductions, credits or allowances between or among related parties, justified on the necessity to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses'.[9]

In *Altera Corp.*, the withdrawn decision of the Court of Appeals noted that after 1934, the Tax Court rejected a strict application of the arm's length standard in favour of a 'fair and reasonable' allocation of income between related parties.[10] Following the increase in abusive transfer pricing practices, in the 1960s, the US Congress authorized the Treasury to apply a profit-split allocation method without amending the law,[11] and criteria such as 'reasonable return', 'full fair value', 'fair price including a reasonable profit', and other similar criteria, were at the time accepted by the Court of Appeals of the Ninth Circuit.[12]

Furthermore, section 482, as amended in December 2017, intensifies the meaning of 'arm's length', concerning transfers of intangible property, in the direction of profit splitting:

> For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

4 An Evolutionary Interpretation of the Arm's Length Standard in the International Tax System

It is acknowledged worldwide by all involved players that a strict interpretation of the arm's length standard causes a recurring problem related to the absence of comparable arm's length transactions between unrelated parties.

Independently of the final decision in *Altera Corp.*, the facts of the case serve as an example to the international tax system, and a motivation for it to move towards profit splitting, at least in those cases where there are no comparable transactions. The issue is whether there is a need to expressly replace the arm's length standard or to merely refer to it as aspirational.

It could be claimed that an evolutionary interpretation of the arm's length standard in the international tax system would be valid, where comparable transactions

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5 *Altera Corp. v. Commissioner*, at 13 & 30.

6 Preamble to the final Treasury Rule 2003, apud, *Altera Corp. v. Commissioner*, at 30.

7 *Altera Corp. v. Commissioner*, at 7.

8 *Altera Corp. v. Commissioner*, at 20.

9 *Altera Corp. v. Commissioner*, at 13.

10 *Altera Corp. v. Commissioner*, at 14.

11 *Altera Corp. v. Commissioner*, at 16.

12 *Altera Corp. v. Commissioner*, at 15.

do not exist, taking into account that its purpose is related to fair allocation of taxing rights between states. Actions 8–10 of the OECD/G20 BEPS project and the OECD Transfer Pricing Guidelines 2017[13] might also be invoked in favour of an evolutionary interpretation of the arm's length standard.

In fact, the OECD Transfer Pricing Guidelines updated in 2017 refer to profit split based on the division of functions (taking into account the assets used and risks assumed), and pleads for 'flexibility by taking into account specific possibly unique, facts and circumstances of the associated enterprises, while still constituting an arm's length approach to the extent that is reflects what independent enterprises reasonably would have done if faced with the same circumstances'.[14]

It is not clear however, whether regulations approved by tax authorities, similar to the ones approved by the US Treasury, would comply with the recommended flexibility.

Moreover, in *Altera Corp.*, both the Tax Court and the dissenting opinion in the Court of Appeals case argued that interpretation of arm's length standard moving away from comparable transactions among unrelated parties is invalid as arbitrary and capricious (because it allegedly does not have a legal basis). Additionally, in the international setting, based on Article 9 of the OECD Model Convention, and unlike the US Revenue Act, it is questionable whether such evolution of the arm's length standard, with no express treaty reference to profit splitting, can be justified based on the need to prevent tax evasion.[15]

This means that the legal standard, be it national or international, should clearly move away from the comparability analysis.

5 The Arm's Length Standard as a Restriction of the EU Fundamental Freedoms

One of the most striking examples of divergent interpretation from the arguments put forward in *Altera Corp.*, is the interpretation by the Court of Justice of the European Union (the Court or ECJ) of the arm's length standard in light of the European Union fundamental freedoms. In fact, application by the EU Member States of the arm's length standard itself – whether there are comparable transactions or not – is held to be a restriction of the fundamental freedoms.

Whereas in the United States, and as mentioned above, the historical element of interpretation justifies the arm's length as a standard to assure parity in taxation of controlled and uncontrolled transactions and corresponding taxpayers, similar domestic rules in an EU Member State have been held to lead 'to unequal treatment in cases involving domestic and foreign transactions since, in a case involving purely domestic transactions, no corrections of income would be made in order to reflect the presumed amount of the remuneration for guarantees granted to subsidiaries'.[16]

The ECJ does not compare cross-border uncontrolled transactions with cross-border controlled transactions, but rather domestic and cross-border controlled transactions, which – in light of the territoriality principle – are incomparable. Instead, the Court asserts that territoriality and symmetry do not relate to the comparability of situations, but rather to the justifications derived from territoriality and the need to preserve the taxing rights of the Member States.

The *Hornbach-Baumarkt* case concerned Hornbach-Baumarkt AG, a public limited company established in Germany which provided comfort letters to a bank. Those comfort letters contained a guarantee statement, so that its Dutch subsidiaries Hornbach Real Estate Groningen BV and Hornbach Real Estate Wateringen BV received bank loans (the granting of the loans was contingent on the provision of these comfort letters). Hornbach Real Estate Groningen BV and Hornbach Real Estate Wateringen BV had negative equity capital and needed those loans in order to continue their business operations. Hornbach-Baumarkt AG provided the comfort letters for no consideration.

The German tax authorities argued that unrelated third parties under the same or similar circumstances, would have agreed on remuneration in exchange for granting such guarantees, and accordingly increased the amount of taxable income of Hornbach-Baumarkt AG. The German referring Tax Court agreed with the tax authorities' correction of the taxpayer's taxable income, taking into account the comparability test and the associated liability risk.[17] However, the referring Tax Court was unsure whether that correction infringed the EU freedom of establishment (thus, leading to the referral to the ECJ).

In *Hornbach-Baumarkt AG*, according to the ECJ, restrictions on the freedom of establishment caused by adjustments under the arm's length standard, may be justified because they 'pursue legitimate objectives

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13 *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2017), paras 2.117–2.119.

14 The *OECD Transfer Pricing Guidelines …*, *supra* n. 13, para. 2.118.

15 No reference to tax avoidance or evasion is made in *OECD Model Tax Convention on Income and on Capital: Commentary on Article 9*. The *OECD Transfer Pricing Guidelines …*, *supra* n. 13, para. 1.2, advises against a presumption of tax avoidance, related to transfer pricing.

16 DE: ECJ, 31 May 2018, Case C-382/16, *Hornbach-Baumarkt AG v. Finanzamt Landau*, ECLI:EU:C:2018:366, para. 13.

17 *Hornbach-Baumkart* (C-382/16), para. 16.

concerning the need to maintain the balanced allocation of the power to tax between the Member States and that of preventing tax avoidance'.[18] In general terms, the justification would be a commercial justification presented as evidence to explain why a transaction had been concluded on non-arm's length terms. If such evidence is not provided, the adjustment by the tax authorities must 'be confined to the part which exceeds what would have been agreed between the companies in question under market conditions'.[19]

This therefore means that, in the absence of comparable (market) conditions, the correction by the tax authorities may not be based on the arm's length standard, but only on abusive behaviour as interpreted by the ECJ.

However, in *Hornbach-Baumarkt AG*, and as mentioned above, the comparability test with transactions between uncontrolled entities was possible and had been carried out by the German tax authorities.

6 Restriction of the Arm's Length Standard by the ECJ: Internal Market Friendly or Non-Parity Against Uncontrolled Transactions?

The ECJ nonetheless proceeded in the assessment of the proportionality principle, by moving away from the arm's length standard. The ECJ did not move towards a profit split method, but rather restricted it. Indeed, the ECJ restricted the arm's length standard by abandoning its historical meaning, as it had been asserted by the German authorities (to achieve free competition between related and unrelated entities) and as it was discussed in *Altera Corp.* (to achieve parity in taxable income, between controlled and uncontrolled arrangements, because it is results-oriented: its goal is parity in taxable income rather than parity in the method of allocation).[20]

In fact, the ECJ added that there might be commercial reasons for a parent company to agree to provide capital on non-arm's length terms. Those commercial reasons could be linked to the purpose of continuation and expansion of the business operations of those foreign companies; to the financial success of the foreign group companies, as well as by a certain responsibility of Hornbach-Baumarkt AG to finance its subsidiaries.

Whereas it can be argued that the expansion of the business operations of foreign companies is an internal-market-friendly argument, the responsibility of Hornbach-Baumarkt AG in financing the subsidiaries, for no consideration, works against parity in taxable income between controlled and uncontrolled arrangements.

Expansion of the business operations of the foreign companies as a commercial justification to restrict the arm's length standard also eliminates the role that this standard plays in the cross-border allocation of taxing rights.

7 Conclusion

There are sound arguments to support the claim that the arm's length standard based on comparable transactions between controlled and uncontrolled parties is obsolete, in the current international economic context that is dominated by transactions among controlled parties, even in the post-BEPS era, and taking into account BEPS Actions 8–10.

The arm's length standard can be interpreted as a results-oriented standard, where its goal is parity in taxable income rather than parity in the method of allocation between controlled and uncontrolled transactions, and in this manner, it could smoothly evolve to a profit split method in the absence of comparable transactions.

However, the fact that different courts – or even different panels in the same Court – will disagree on the interpretation of the arm's length standard recommends that any move towards profit splitting be expressly achieved by law or tax treaty: leaving application of the arm's length standard to different courts could lead to opposite results.

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18 *Hornbach-Baumkart* (C-382/16), para. 20.

19 BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle (SGI) v. Belgian State*, ECLI:EU:C:2010:26, paras 71 & 72; *Hornbach-Baumkart* (C-382/16), para. 49.

20 *Altera Corp. v. Commissioner*, at 7.