The Value of a Principle ... the Arm's Length Principle^{*}

The value of a principle is the number of things it will explain (Ralph Waldo Emerson)

I FROM AN ARTICULATED PRINCIPLE ANCHORED BY AGREEMENT ON INTERPRETIVE GUIDELINES TO A NEGOTIATED APPROACH?

One of the benefits of having some mileage in the tax profession is the observation that the design of international tax rules has been rooted in a principled approach for approximately a century. The Cambridge Dictionary describes 'principled' as 'always behaving in an honest and moral way'. Interestingly enough and irrespective of all of the valid claims about the international tax system being outdated, particularly when in the perspective of today's economic, societal, and economic pressures, 'principled' is at the verge of being overhauled by 'politically-steered-outcome-driven'. The Cambridge Dictionary remains (at present) silent on the latter notion.

2 A CALL FOR CHANGE REQUIRES KNOWING THE DIRECTION OF TRAVEL

Speaking on 28 October 2020 before the European Parliament's permanent subcommittee on tax matters, Pascal Saint-Amans stated that OECD members must work towards an agreement to reform 'durably' transfer pricing rules, even if it takes years. 'The deadline cannot be postponed eternally' and, if the process fails, it will be 'adjourned until political conditions are met to restart global discussions'.¹

The immediate and probably more burning question is whether the OECD will be successful in crafting consensus-based rules on the reallocation of *above-normal profitability* by mid-2021. Over half of the recently sounded senior tax professionals casted serious doubts.²

Is this an argument for the status quo? The answer is simple: NO. Public tolerance for tax avoidance is eroding and the root of the issue is anything but straightforward amidst a highly mediatized debate. 'The global economy is no longer delivering what is needed', Bob Moritz³ mentions on the World Economic Forum Blog. 'While it remains the most powerful generator of social progress, it depends on a system of rules and norms – and now these aren't working. Social progress has become decoupled from economic progress and Covid-19 is making the flows even more apparent'.

Digesting this through a transfer pricing perspective shows that unprecedented parameters serve as a (moral) compass throughout the journey to make the rules 'better'. According to Harvard Professor Stefanie Stantcheva, support for tax policy most strongly correlates with views on fairness and the benefits of redistribution. Efficiency concerns play a more minor role in people's minds, and yet fairness is in the eye of the beholder.⁴ It is hence tempting to craft rules by simply letting reign what is perceived as 'just and reasonable'.⁵

The current era of multi-stakeholder capitalism creates an interesting dynamic. It will be pivotal to design a set of agreed international tax rules anchored by a grounding force that has some tolerance for swift changes in tax policy, business models, and economic/trade evolution in the years to come.

Notes

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¹ E. Lamer, *Status Quo on Digital Taxation Isn't an Option, Saint-Amans Says*, Tax Notes Today Int'l (29 Oct. 2020).

² PwC webcast, 50% while over 70% at a TEI Executives Institute (Canada Branch) (16 Nov. 2020).

³ R. E. Moritz, *To Reinvent the Future, We Must All Work Together* (17 July 2020), <https://www.weforum.org/agenda/2020/07/to-reinvent-the-future-we-must-all-work-together/> (accessed 23 Nov. 2020).

⁴ S. Stantcheva, *Understanding Tax Policy: How Do People Reason?* NBER Working Paper No w27699 (Aug. 2020).

⁵ On the notion 'just and reasonable', reference can be made to J. Schwarz, *Allocation Issues: Transfer Pricing and Tax Avoidance: Just and Reasonable Solutions?*, Kluwer International Tax Blog (16 Nov. 2020), <https://bit.ly/38JKpzL#taxlaw#taxavoidance#transferpricing#corporatefinance#oilandgas#internationaltaxation> (accessed 16 Nov. 2020).

Throughout its existence, the current international profit allocation regime that has remained in place so long has been anchored in the *arm's length principle*, which is rationally articulated. For decades now, most governments have relied on some form of it in transfer pricing to help identify the circumstances in which corporate profits are recognized in one jurisdiction versus another. While criticized for various perceived deficiencies, it has been an animating principle that has helped preserve some measure of certainty in the international tax arena for a substantial period of time. The legal and economic rationales behind the arm's length principle are known and shaped by multilateral consensus and provide reasonable certainty and administrative grounding.

The history of the arm's length principle is captured through several interesting reads,⁶ particularly when analysing how it evolved since initially being sparked by the intent of anti-avoidance. In the absence of unitary taxation, abuse was the inspiring source of its conception under Mitchell B. Carroll⁷.

The current debate around the arm's length principle predominantly stems from the fact that transfer pricing is not an exact science. Without compromising the merits of the principle in itself, the transfer pricing practitioner is (or should be) cognizant of the flaws caused by organizational economics when funnelling potential comparables into the holy grail that is also known as *the arm's length range*. There is hence a margin of appreciation left to the taxpayer, and some like that more than others. It is tempting for the practitioner to become complacent, especially when reading about transfer pricing being an art rather than a science. On the contrary there is academic work claiming that the margin of appreciation left to the taxpayer leads to unhealthy results, particularly as the arm's length principle affords opportunities to countries to use that same flexibility to improve their competitiveness or the global competitiveness of their businesses.⁸ Similarly transfer pricing may be considered as an (alleged) tool for luring inbound intra-group cross-border investment; an instrument of (unfair) tax competition; or even illegal state aid. It is needless to state that, when capital import/export neutrality comes under pressure, surging political attention does not come by surprise.

3 THE NEEDLE(S) IN THE HAYSTACK ... COMPARABLES

One of the main recurring criticisms is that mimicking third party behaviour is meaningless when transacting in

an atmosphere of economic solidarity stemming from the way enterprises are legally organized. Intangibles are the scapegoat as if groups randomly price them internally in an opportunistic attempt to shelter economic rent in low tax *investment hubs*.

Professor Lorraine Eden supports the arm's length standard, particularly for those using what she refers to as the *arrows of logic, economics and pragmatism*. She disregards allegations about transfer pricing being ordinarily *abusive*, being unworkable to accommodate the digital economy, and unable to actually work in the absence of comparables due to the presence of synergies.⁹

4 WHEN THE GOING GETS (EVEN MORE) TOUGH ... COVID-19

Building further on the above allegations, it may be questioned whether it is true that the economic theory of the firm and the arm's length principle mix as oil and water.

Winston Churchill is credited with stating '*Never let a good crisis go to waste*' when World War II was coming to an end. The current pandemic seems to have unlocked an avalanche of instances in which use is made of this quote, likely provoking an increasing sense of indigestion with the reader. It couldn't however be hardly more relevant than today.

The rationale is fairly straightforward. Intercompany pricing arrangements stemming from before the outbreak of Coronavirus diseases 2019 (COVID-19) have come under significant stress due to the unexpected and unprecedented impact of the pandemic as well as governments' attempts to save lives. In related party settings, three questions have quickly arisen. The first is about *who* should bear the burden followed by the question on timing, i.e. *when* do they need to be borne and, finally, how should related parties shoulder the unexpected costs or the *how much* question. It may be worthwhile addressing them in two commonly used intercompany pricing models: licensing and financing. The purpose is not to develop a rationale tapping from statistical modelling such as a regression analysis for making, e.g. changes in intercompany pricing mechanisms during the year. Instead, the aim is simply to illustrate how the actual delineation of transactions can leverage real life evidence on how parties revisit contractual relationships when the underlying conditions are in a flux.

Notes

⁶ R. Collier & J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS* (Oxford University Press 2017); L. E. Schoueri, *Arm's Length – Beyond the Guidelines of the OECD*, 69(12) Bull. for Int'l Tax'n (2015).

⁷ M. B. Carroll, *Taxation of foreign and National Enterprises*, Volume 4: Methods of Allocating Taxable Income 60 (League of Nations 1933).

⁸ P. J. Wattel, *Stateless Income, State Aid and the (Which?) Arm's Length Principle*, 44(11) Intertax 791 (2016).

⁹ L. Eden, *Insight – David and the three Goliaths – defending the Arm's Length Principle*, Bloomberg Tax Transfer Pricing Report (14 Sept. 2020), <https://news.bloombergtax.com/transfer-pricing/insight-david-and-the-three-goliaths-defending-the-arms-length-principle> (accessed 25 Nov. 2020).

4.1 Licensing Arrangements

In related party licensing and franchising arrangements, the functions and risks agreed upon by the parties prior to the pandemic are not likely to have envisioned such a dramatic change in both top line revenues and cost structures. In the consumer-facing sector, for example, companies experienced a sharp and unexpected change in their business circumstances.

One of the avenues for determining who bears these variances relates to the royalty payments due by licensees and franchisees. For example, many companies in the restaurant industry¹⁰ operate under franchise arrangements with the individual limited-risk franchisees paying royalties to the parent or brand owner. As a result of COVID, many companies were forced to reevaluate their royalty arrangements which ultimately resulted in a reduction or complete waiver of these royalties.¹¹

In the industrial sector, for example, the US Government attended to requests for royalty relief from oil and gas companies that lease federal lands for extraction following the significant reductions in industry revenues^{12,13}. As the pandemic continues, non-tax actions taken by governments and companies are likely to continue to shape the business environment.

As such, measures taken in response to the economic downturn can be used to support how much of a modification to intercompany licensing arrangements are related to the economic downturn – industry, company, and country specifics will dictate the size of the modification.

4.2 Financing Terms

Prior to COVID, a renegotiation of financing terms primarily followed a widespread change in interest rates. However, due to COVID, many banks and lenders offered a revision of the lending terms to help their lending partners continue operations. In the banking sector, the initial wave of renegotiations reduced or eliminated interest payments and restructured periodic principal

payments on loans.¹⁴ Further, several car manufacturers responded similarly by offering customers relief on interest and monthly payments.¹⁵

As the economic downturn rolled through the summer, the relief offered by both financial institutions and car manufacturers mostly continued and were sometimes expanded.¹⁶ However, the relief offered by lenders has not been unwavering as, in October, several commercial real estate landlords ceased payment deferrals and are now seeking lease payments amid struggles to pay mortgages.¹⁷

The actions taken by these banks and car manufacturers in their third-party arrangements can provide guidance as to when related parties may factor in the impact from the pandemic. Further, the widespread modifications of financing arrangements among third parties may yield contemporaneous support for deferrals or forgiving certain intercompany financial commitments if challenged by a taxing authority.

5 CONCLUDING THOUGHTS

The design of an anti-avoidance mechanism formed the genesis of transfer pricing legislation almost a century ago. It has evolved towards a means to allocate a *fair* share of profits. Levelling the global playing field amidst the societal, environmental, and economic pressures faced by the world economy appears to provoke a strong political appeal to criticize the arm's length standard.

There are few objective, subjective, or even emotional angles from which the arm's length principle has not (yet) been commented on, assessed, screened, criticized, challenged, or applauded. It will be interesting to see whether the OECD Pillar 1 work on tackling the challenges of the digital economy will widen the door to formulary apportionment. Indeed, Amount A eliminates part of *above-normal-profitability* outside the arm's length standard for reallocation over market jurisdictions. The direction of travel is not (yet) entirely clear. However, Amount A will be the *first mover* in terms of wounding the arm's length principle given the snail's pace earmarking the EU's progress related to the Common Consolidated Corporate Tax Base.

Notes

¹⁰ Fast Food Chains Ease Rent, Fees for Franchisees in US & Canada Due to Coronavirus, Shutdown, News 18 World (20 Mar. 2020), <https://www.news18.com/news/world/fast-food-chains-ease-rent-fees-for-franchisees-in-us-canada-due-to-coronavirus-shutdown-2543631.html> (accessed 25 Nov. 2020).

¹¹ J. Mazer & E. Dean, *Covid-19 Franchise Industry News, Articles, Advice & Resources* (26 May 2020), https://www.franchising.com/articles/how_franchise_brands_are_dealing_with_their_disrupted_supply_chains.html.

¹² C. Eaton, *We Pulled the Plug: As Oil Prices Plunge Drillers in the Gulf of Mexico Shut Off Wells-2nd Update*, Wall St. J. (22 Apr. 2020), <https://www.wsj.com/articles/we-pulled-the-plug-as-oil-prices-plunge-drillers-in-the-gulf-shut-off-wells-11587558182> (accessed 7 Dec. 2020).

¹³ N. Bowlin, *Ailing Oil Companies Get a Pass on Royalties-According to Documents Obtained by High Country News, the BLM by Passed Normal Processes to Provide Pandemic Relief*, High Country News (21 May 2020), <https://www.hcn.org/articles/south-bureau-of-land-management-ailing-oil-companies-get-a-pass-on-royalties> (accessed 7 July 2020).

¹⁴ L. G. Tarpley, *34 Banks Offering Payment Assistance for Customers Impacted by the Coronavirus*, Business Insider (15 May 2020), <https://www.businessinsider.com/personal-finance/banks-helping-customers-impacted-by-coronavirus-2020-4?international=true&r=US&IR=T> (accessed 23 Nov. 2020).

¹⁵ U. Karkaria, *BMW, Honda Launch Relief Plans for N.A. Dealerships*, Automotive News (20 Mar. 2020), <https://www.autonews.com/dealers/bmw-honda-launch-relief-plans-na-dealerships> (accessed 7 Dec. 2020).

¹⁶ P. W. Howard, *Fear of Job Loss, Uncertainty Stalls Car Buyers – so Ford Came Up with an Idea*, USA Today Online (29 June 2020) (accessed 29 June 2020).

¹⁷ E. Fung, *Lenders Cracking Down on Mall Owners Behind on the Mortgage*, Wall St. J. (27 Oct. 2020), <https://www.wsj.com/articles/lenders-cracking-down-on-mall-owners-behind-on-the-mortgage-11603800000> (accessed 29 Oct. 2020).

The arm's length principle is currently the prevailing standard. Even though there is appreciation for its imperfectness, there is an abundance of empirical evidence around third-party behaviour that the taxpayer can rely on when establishing and monitoring intercompany prices. Indeed, even as the pandemic continues to affect the global economy, the arm's length standard requires companies to set their transfer prices in accordance with how unrelated parties operate. Evidence of third party behaviour during the ongoing Covid-19 pandemic exists and demonstrates how parties operating under open-market conditions adapt to the changed circumstances from

the perspective of who bears the impact of the pandemic, when and for how long, and how much they share among the parties. This can help tax directors apply the arm's length standard in a continuously fluid business environment. After all, going back to the basics strengthens the foundation.

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