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"Transfer pricing approaches: arm's length versus formulary apportionment"

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Trabajo Fin de Grado

"Transfer pricing approaches: arm's length versus formulary apportionment"

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PRESENTACIÓN

El presente trabajo ha sido desarrollado durante el 5º curso del Doble Grado en Derecho y Administración y Dirección de Empresas de la Universidad de Alcalá. El trabajo se ha realizado en colaboración con el Departamento de Ciencias Jurídicas de la Universidad de Alcalá y ha sido supervisado por el Dr. D. Manuel Jesús Lucas Durán.

Abstract

Globalization, along with the technical and technological development, has changed business structure in the recent decades. Companies no longer provide only tangible goods, but also services and other intangibles.
This evolution has had its effect on corporate taxation, currently ruled under the arm's length principle. The aim of this paper is to analyse the most important transfer pricing rules and raise the question about its expected evolution: will the arm's length principle still be the standard or is it possible that formulary apportionment take over?

Keywords: Arm's length principle, Formulary Apportionment, Transfer pricing

Resumen
La globalización, junto con los avances técnicos y tecnológicos, ha cambiado la estructura empresarial en las últimas décadas. Las empresas ya no ofrecen sólo bienes tangibles, sino también servicios y otros intangibles.
Esta evolución también ha tenido su impacto en la tributación empresarial, actualmente regulada por el principio de plena competencia. El objetivo de este trabajo es analizar la normativa de precios de transferencia más relevante y plantear la pregunta sobre su evolución esperada: ¿seguirá el principio de libre competencia siendo la regla general o es posible que la distribución de la base imponible consolidada se imponga?

Palabras clave: Distribución de la base imponible consolidada, Precios de transferencia, Principio de libre competencia

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ACRONYMS AND ABBREVIATIONS

AC	Arbitration Convention
ALP	Arm's Length Principle
APA	Advanced Pricing Agreement
EC	European Commission
BEPS	Base Erosion and Profit Shifting
EU	European Union
FA	Formulary Apportionment
JTPF	Joint Transfer Pricing Forum
MAP	Mutual Agreement Procedure
MNE	Multinational Enterprises
MS	Member State
OECD	Organization for Economic Co-operation and Development
TP	Transfer Pricing
UN	United Nations

INTRODUCTION

The globalization process over the last decades has provided economic agents multiple opportunities to optimize their structures and benefits in terms of location and costs. Free movement of capital and labour have made it possible for Multinational Enterprises (hereinafter MNE) to locate their manufacturing bases and operational departments in several different countries, according to a previous market study and a detailed plan designed in order to reduce the overall costs of products and services.

This generally adopted strategy has brought many benefits for both enterprises and countries involved. Mainly, we could mention the amount of jobs created in the countries receiving the new operational bases and the costs reduction for the businesses following this strategy.

However, the fact that MNE locate their productive activities in regions geographically distant from the regions of final use or from the locations of their customers, has had an impact on their tax obligations, as different domestic tax systems interact. This interaction has led to frictions and gaps that MNE have taken advantage of by implementing aggressive tax planning in order to minimize their tax burden.

International efforts have usually been made to prevent double taxation through international standards and recognition of bilateral agreements. However, in the last years it has become necessary to implement new tools and international standard procedures in order to prevent double non- taxation or low taxation as a consequence of artificial segregation of taxable income and the activities that generate it. Intra-group operations that manipulate the MNE's tax burden in the various countries in which they operate, with the outcome of minimizing the overall corporate tax amount, are among the most worrying practices.

One of the most relevant initiatives is the OECD Action Plan to prevent Base Erosion and Profit Shifting (hereinafter BEPS), which has been launched by the G20 and OECD in 2013. This project has detected the main harmful tax practices put into action by MNE due to the lack of international tax coherence, and identified the actions needed to tackle or prevent them as well as set a deadline to define actions that would be helpful for tax administrations to fight international tax avoidance.

As for the object of this paper, the most important actions of the BEPS Project are Action 13 (Re- examine transfer pricing documentation), on one hand, and Action 8 (Assure that transfer pricing outcomes are in line with value creation- Intangibles), on the other hand. In this document it will be first analysed the general principles and methods applied for transfer pricing, with the overview of the main international organizations that have approached the topic: the Organization for Economic Co-operation and Development, the United Nations and the European Union.

Then it will be analyzed the arm's length principle (hereinafter ALP), explaining as a first step the methods recognized for calculating transfer prices under this principle. Also, the problems arising from its application to intangibles and in developing countries are going to be addressed.

In third place, the Formulary Apportionment (hereinafter FA) is going to be analyzed as a possible alternative to the ALP in international corporate tax.

I. TRANSFER PRICING: GENERAL OVERVIEW AND MAIN ISSUES

Given that national sovereignty in taxation could be defined as the "ability of a nation to pursue whatever tax policy it chooses, unfettered by external influences" [1], it is clear that globalization, with the increase of MNE and cross-border transactions, has limited national sovereignty in taxation because tax administrations are now directly or indirectly influenced by external forces.

One of these forces is the market-induced pressure on tax systems, being especially interesting to mention here how countries are limited when establishing their statutory tax rates in order to avoid MNEs' shifting of tax base: if a country has a statutory tax rate higher than the international or regional average, there is a risk that MNEs will shift taxable income out of that country and transfer deductions into it, without these operations being a result of the company's reallocation of economic activity, but just a superficial transaction whose main purpose is to minimize the MNE's tax burden[2].

Transfer pricing (hereinafter TP) is important in the international tax context as it influences the profit that MNEs report in each country in which they conduct business and therefore, the amount of tax paid in each jurisdiction, as detailed below[3].

Even though TP should not be confused with tax avoidance[4], as it is a normal aspect of how MNEs operate, its manipulation is within the most commonly used mechanisms of profit shifting[5].

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[1] MCLURE, C.E. Jr., "Globalization, Tax Rules and National Sovereignty", *International Bureau of Fiscal Affairs* August 2001, p. 328-329.

[2] Ibidem, p. 329.

[3] OWENS, J., "The Taxation of Multinational Enterprises: an elusive balance", *Bulletin for International Taxation*, August 2013, p. 442.

[4] According to *OECD Glossary of Tax Terms* (http://www.oecd.org/ctp/glossaryoftaxterms.htm, last visited 29 May 2015) it is: "A term that is difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow".

[5] According to *OECD Glossary of Tax Terms* (http://www.oecd.org/ctp/glossaryoftaxterms.htm, last visited 29 May 2015) it is: "Allocation of income and expenses between related corporations or branches of the same legal entity (e.g. by using transfer pricing) in order to reduce the overall tax liability of the group or corporation."

1. Transfer pricing: definition and international regulation

1.1 Definition of transfer pricing and other keywords

According to the OECD Glossary of Tax Terms, transfer pricing is "the price charged by a company for goods, services or intangible property to a subsidiary or other related company"[6].

Similarly, the UN defines transfer pricing as "the general term for the pricing of cross-border, intra-firm transactions between related parties", stating that the setting of prices for a transaction will require the application of an appropriate method, as it will be seen in Part II of this paper[7].

Over the last decades, transfer pricing has gained much attention, as the volume of cross-border transactions within related parties has grown, mainly based on profitability reasons: given that a German MNE has, for instance, a subsidiary in Bulgaria, it might be much quicker, easier and require less commercial and administrative efforts to agree on the terms of an asset's transaction with the subsidiary than with a Bulgarian independent enterprise.

Stated the relevance of the concept of "associated enterprise" in the transfer pricing context, it is surprising that there is no proper definition of it yet. However, it seems that the sense given to the term in both OECD (2014) and UN (2011) Model Tax Conventions has been widely accepted: two enterprises are considered to be associated where one of them participates directly or indirectly in the management, control or capital of the other or where the same persons participate directly or indirectly in the management, control or capital of both enterprises[8].

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[6] Cfr. http://www.oecd.org/ctp/glossaryoftaxterms.htm (last visited 5/7/2015). That glossary refers that "Abusive transfer pricing occurs when income and expenses are improperly allocated for the purpose of reducing taxable income".

[7] UNITED NATIONS, *Practical Manual on Transfer Pricing for Developing Countries,* New York, 2013, at Chapter I, para. 1.6., reachable at http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf (last visited 28/06/2015).

[8] Both OECD, *Model Tax Convention on Income and on Capital*, 2014, reachable at http://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf (last visited 15/06/2015) and UN, *Model Double Taxation Convention between Developed and Developing Countries,* 2011, reachable

It is important to note here that Permanent Establishment, as defined in Articles 5 of both OECD (2010) and UN (2011) Model Tax Conventions, is considered to be an associated enterprise for the purposes of transfer pricing[9].

Also, even if treated in detail in Part II, it should be mentioned here that the OECD Model Tax Convention embodies in its Article 9 the arm's length principle, widely accepted into most transfer pricing regulations, when after defining "associated enterprises", reads as follows:

> and in either case conditions are made or imposed between the two 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.

Therefore, as the UN points out in its *Practical Manual on Transfer Pricing for Developing Countries*, the underlying idea behind arm's length principle is to place both controlled and uncontrolled transactions on equal terms as far as tax advantages that they create concerns[10].

1.2 International regulation of transfer pricing

Considering that transfer pricing usually involves more than one tax jurisdiction, as MNE operate on a global basis, it has been observed that unilateral tax regulation and unilateral adjustments lead to double taxation, for a simple reason: more than one tax authority might consider that the same income or profit is taxable under its jurisdiction[11].

Therefore, even if countries still need to develop and implement transfer pricing in their domestic tax laws, in order to do so without giving place to international incoherence, it

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at http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf (last visited 15/06/2015) dedicate their Article 9 to associated enterprises.

[9] *Permanent establishment* is defined in both Model Tax Conventions as "a fixed place of business through which the business of an enterprise is fully or partly carried on", including in this definition independent agents and excluding "the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise", as well as the maintenance of a fixe place for the solely purpose of carrying on any preparatory or auxiliary activity for the enterprise.

[10] Supra note 7, at Chapter I, para. 1.4.12.

[11] Supra note 3.

is essential that transfer pricing guidelines are developed by the main international organizations. Thereby, all parties involved (MNE, tax authorities and tax advisors) would be given special and common tools to deal with the issues that may arise in transfer pricing[12].

However, transfer pricing guidelines have been set from different perspectives, depending on the author organization and its membership and purposes. One of the most relevant is the OECD *Transfer Pricing Guidelines*[13], but also the UN has developed its *Practical Manual on Transfer Pricing*, from the outlook of developing countries.

Finally, the European Union (hereinafter EU) has also made efforts in preventing double taxation, mainly through the Arbitration Convention (hereinafter AC) and the Joint Transfer Pricing Forum (hereinafter JTPF), that assists and advises the European Commission (hereinafter EC) on TP tax matters[14].

1.2.1 Transfer pricing regulation within the OECD: Transfer Pricing Guidelines and BEPS Project

The development of Internet and the electronic commerce, along with globalization, have raised serious problems for transfer pricing regulations, which were first implemented on a time when the majority of products were tangible, most transactions were within

[12] LAMBERT G. A., "The UN Practical Manual on Transfer Pricing for Developing Countries: Should it depart from the OECD Transfer Pricing Guidelines?", *International Transfer Pricing Journal,* January/February 2012, p. 11.

[13] OECD*, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* 2010, OECD Publishing, Paris, reachable at http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm (last visited 02/06/2015).

[14]European Union, Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/436/EEC), *Official Journal of the European Communities, L 225,* July 20, 1990, pp.10- 16, reachable at http://eur-lex.europa.eu/resource.html?uri=cellar:ba007830-4ed1-43f9-8c98-c397c79373d8.0008.02/DOC_1&format=PDF (last visited 02/06/2015). See also the Protocol amending that Convention (*Official Journal of the European Communities* 202, July 16, 1999, pp. 1-11), and for clarifications concerning some practical aspects of the Convention, see the Revised Code of Conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (*Official Journal of the European Union* C 322, December, 30, 2009, pp. 1-10).

independent parties, telecommunications services did not have a significant market power and international investment was minor[15].

Hence, there is a need to adapt the transfer pricing system to this evolution of the real world and improve the mechanisms whose efficiency has yet not been proved. The OECD has shown a strong preference for adapting and improving the arm's length principle, instead of considering its replacement by an alternative approach[16].

1.2.1.1 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

Since 1979, the OECD provides practical guidance on TP. As the number of MNE and transactions within associated enterprises was increasing, the OECD Member States decided that administrative guidance was needed on that topic and therefore, elaborated a report in 1979 and a second one in 1984. The first of them pointed out the main problems posed by TP and the acceptable solutions from a tax point of view, while the second report focused on the Mutual Agreement Procedure (hereinafter MAP), TP in the banking sector and allocation of central costs[17].

Following the developments in international trade and technology, workings on the consolidation and update of the previous reports started in 1992, publishing a new version of the guidelines in 1995, which has been continuously updated with the introduction of more and more TP related topics, like cost contribution arrangements or intangibles[18].

The 2010 version of the OECD Guidelines for Multinational Enterprises and Tax Administrations specifies five methods, explained in part II, for applying arm's length conditions to operations between associated enterprises, without imposing a hierarchical

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[15] *Supra note* 1, p. 333-334.

[16] ANDRUS, J. L., "Tax Avoidance and Transfer Pricing", *Asia- Pacific Tax Bulletin,* November/December 2012, p. 435.

[17] United Nations Secretariat, , "Transfer Pricing History C State of the Art C Perspectives", *Ad Hoc Group of Experts on International Cooperation in Tax Matters*, 2001, Geneva pp. 7-8, reachable at http://unpan1.un.org/intradoc/groups/public/documents/un/unpan004399.pdf (last visited 16/06/2015).

[18] Ibidem, pp. 19-20.

order. Therefore, the most appropriate transfer pricing method to the circumstances of the case should be applied[19].

This standard- ALP is generally considered suitable for all transfer pricing situations, but there are some specific cases in which OECD admits that its application is too complicated or leads to not realistic outcomes.

That is the case of safe harbours, defined by the OECD as "a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime"[20]. For the eligible taxpayers, the main benefits of safe harbours are the simplification of compliance, as well as the reduction of its costs, and the certainty that the prices of the transactions will be accepted by the tax administrations, without further controls. As for the tax authorities, the main benefit is the simplicity it offers: the public resources can be optimized, as the low risk or non- complicated transactions do not need to be examined.

There are also a few concerns about safe harbours, such as the divergence from the arm's length principle or the risks of double taxation or double non- taxation, but the OECD has encouraged its use for small taxpayers and less complex transactions, on a bilateral or multilateral basis[21].

1.2.1.2 BEPS Project

Given the challenging international tax environment, the G20 leaders called on the OECD to develop an Action Plan, in order to address Base Erosion and Profit Shifting (BEPS) in an inclusive and multilateral way. The Action Plan was finally presented in 2013, with

[19] Supra note 13, at Chapter II, para. 2.2.

[20] OECD, *Revised Section E on safe harbours in Chapter IV of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* OECD Publishing, Paris, 2013, para. 4.100. http://www.oecd.org/ctp/transfer-pricing/Revised-Section-E-Safe-Harbours-TP-Guidelines.pdf (last visited 28/04/2015).

[21] Ibidem, para. 4.125- 4.131.

a total of 15 specific actions [22]. For the purposes of this paper, as we have mentioned, the main actions would be Action 8 (Assure that transfer pricing outcomes are in line with value creation: intangibles) and Action 13 (Re- examine transfer pricing documentation). As the treatment given to both issues is much more detailed and clarifying in the BEPS Project than in the OECD Guidelines, Chapter V and Chapter VI of the latter have been replaced by the Action 13 2014 Deliverable[23] and Action 8 2014 Deliverable[24], respectively.

At first sight, the BEPS Project seemed to be too ambitious, as it was launched as a two-year working program, with many and significant changes being proposed, involving a high workload, as public consultations were made during the process, in order to take into account taxpayers', tax experts' and tax authorities' opinion. However, the timelines have been respected up to the moment and some of the pending Deliverables due for September and December 2015 are already in the public consultation stage[25].

Even if other issues are addressed, such as the challenges posed by the digital economy, the main focus of BEPS Project is the avoidance of double non- taxation, by revising and changing the actual international tax system in various aspects, defined in each Action of the Plan. When asked about it, Pascal Saint- Amans, the Director of the OECD Centre for Tax Policy and Administration, confirmed that the main concern about the outcome of the initiative is whether uniformity will be reached and non-OECD countries will follow the BEPS Project guidelines, or there will still be different approaches from developed

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[22] OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, 2013, reachable at http://dx.doi.org/10.1787/9789264202719-en (last visited 17/06/2015).

[23]OECD, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, reachable at http://dx.doi.org/10.1787/9789264219236-en (last visited 23/06/2015).

[24]OECD, *Guidance on Transfer Pricing Aspects of Intangibles*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, reachable at http://dx.doi.org/10.1787/9789264219212-en (last visited 19/06/2015).

[25]HERRINGTON, M. and LOWELL, C., "The BEPS Project: Planning in Anticipation", *International Transfer Pricing Journal*, May 2014, pp. 2-3, reachable at http://www.mwe.com/files/Publication/5a7dc05e-7589-49dd-a362-81f9406f6d36/Presentation/PublicationAttachment/b1ee481b-4717-487f-a474-8a611ff1770d/ITPJ_2014_BEPS_Project_Planning_Anticipation.pdf? (last visited 18/06/2015).

and developing countries, with the result of formulary apportionment or unitary taxation being applied in the latter[26].

1.2.2 UN Practical Manual on Transfer Pricing for Developing Countries

Even if TP has become all over the world an important instrument for tax administrations to retain the appropriate tax revenue, in the case of developing countries its importance is even more crucial, as it also affects the investment climate perceived by foreign investors. Given that foreign direct investment in developing countries has increased over 300% from 2000 to 2010, tax authorities need to implement a TP framework, in order to assure investors a predictable and transparent tax treatment[27].

Developing countries, when dealing with transfer pricing, usually encounter a major problem: lack of information for comparability analysis. As most markets in developing countries import technology and goods for consumption, few or none comparable data is available on new business sectors that are landing as a result of the globalization process and technology development, along with economic growth and positive future expectations[28].

As previously seen, the arm's length principle requires transactions within associated enterprises to be set at the prices they would have been set between independent parties. Therefore, when examining a controlled transaction, tax authorities need to compare it to an uncontrolled transaction. UN determines that "a controlled and an uncontrolled transaction are regarded as comparable if the economically relevant characteristics of both transactions and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm's length result"[29].

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[26]SAINT- AMANS, P., (February, 2014), *"An interview with Pascal Saint- Amans"*, reachable at http://www.pwc.com/en_GX/gx/tax/tax-policy-administration/beps/assets/pwc-tax-interview-transcript.pdf (last visited 06/06/2015).

[27]STERN, R., "Transfer Pricing for Developing Countries", Commonwealth Business Council, *Commonwealth Trade and Investment Report,* 2013, pp. 87-88, reachable at https://www.wbginvestmentclimate.org/advisory-services/regulatory-simplification/business-taxation/upload/CBC_Trade__Investment_Low_Res.pdf (last visited 21/06/2015).

[28] Supra note 12, pp. 19-20.

[29] Supra note 7, at Chapter V, para. 5.1.5.

Therefore, in the lack of comparables, ALP's application becomes very difficult, as all transfer pricing methods proposed under the ALP depend, to a greater or lesser degree, on comparables[30].

In addition, TP documentation requirements involve high costs for MNE, as they might not be uniform in all the countries in which they operate and extra efforts need to be made in order to submit the required documentation in each country. Also, documentations must usually be provided in the local official language, which increases even more the costs for MNE. In the case of developing countries, one of the proposed solutions is that taxpayers deliver all the information in its original language and translate only the parts regarded as essential by tax authorities for conducting tax assessment[31].

Besides, tax authorities' resources in developing countries tend to be limited and transfer pricing examinations require considerable human and capital resources, such as audit resources[32]. Considering this, a plausible option for developing countries would be to apply safe harbours to a certain category of MNE, in order to focus their limited resources to more complicated transfer pricing cases, such as high- margin transactions.

However, in order to protect both taxpayers and tax administrations, safe harbours should be always considered under the OECD requirements previously mentioned, as the UN Manual doesn't offer a specific guideline on safe harbours[33].

Also, it should be noted that the OECD has gradually increased developing countries' participation in the BEPS Project, given that global coherence is needed. The outcome statement of the Task Force on Tax and Development meeting from 18th March 2015 shows that one of the priorities is to assist developing countries in building effective transfer pricing regimes [34].

[30] Supra note 12, p. 20.

[31] Supra note 12, p. 30.

[32] Supra note 12, p. 19.

[33] Supra note 12, p. 20-21.

[34] For more details: http://www.oecd.org/tax/tax-global/co-chairs-statement-task-force-tax-development-march-2015.pdf (last visited 4th April 2015).

1.2.3 Transfer Pricing regulation within the European Union

Since its foundation in 1957, the EU has progressively worked towards integration of all its Member States (hereinafter MS). The most relevant instrument in order to do so has been the project of the Single Market, whose basic pillars are free movement of people, goods, capital and services. Even though relevant achievements have been accomplished, such as the removal of border controls, the creation of a single currency- even if not used in all MS- or the Schengen Convention, there are still multiple barriers that hinder the progress to a deeper integration[35].

One of those barriers are of fiscal origin, mainly Value Added Tax (hereinafter VAT) and corporate tax, as MS are free to design their own tax systems, with the outcome of having 28 different corporate tax systems within the EU. As a consequence, MNE operating within the EU in more than one MS, will encounter many difficulties, as they have to coordinate 28 different accounting and corporate tax systems [36].

Given the EU's aim of achieving economic integration, it is important to work on the development of new tools that would help to avoid the current barriers of progress towards a Single Market. As for transfer pricing, the EU has mostly agreed with the OECD Guidelines, but still harmonization measures are needed in the specific European context. Therefore, within the most important figures, we can mention the AC and the JTPF.

1.2.3.1 Arbitration Convention (90/436/EEC)

The EC proposed in 1976 the creation of a Directive for the elimination of double taxation in transfer pricing cases within associated enterprises from different MS of the EU. Eventually, the proposal was formalized as a Convention in 1990, coming into effect in 1995, after the ratification of all MS.

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[35] JAMES, W., "The Single Market", *Civitas Institute for the Study of Civil Society*, 2007, reachable at http://www.civitas.org.uk/eufacts/download/EC.1.Single%20Market.pdf (last visited 23/06/2015).

[36] ILZKOVITZ, F., DIERX, A., KOVACS, V., and SOUSA, N., "Steps towards a deeper economic integration: the Internal Market in the 21st Century", *European Commission's Directorate- General for Economic and Financial Affairs,* 2007, p. 58, reachable at http://ec.europa.eu/economy_finance/publications/publication784_en.pdf (last visited 24/06/2015).

Article 1 of the Convention indicates its scope of application, by reading that it "shall apply where, for the purposes of taxation, profits which are included in the profits of an enterprise of a Contracting State are also included or are also likely to be included in the profits of an enterprise of another Contracting State on the grounds that the principles set out in Article 4 and applied either directly or in corresponding provisions of the law of the State concerned have not been observed." As for Article 4, it embodies the arm's length principle in the same terms as the OECD. Hence, the Convention is a mechanism of avoiding double taxation caused by profit adjustments in the context of transfer pricing[37].

The dispute resolution method proposed by the Convention has three different stages: unilateral adjustment, MAP and arbitration procedure[38]. Still, the effectiveness of the two first stages of this method to reduce double taxation is questionable, as the power to decide and resolve is still held by the MS involved and it is expectable that each one of them will try to solve the dispute in the most favorable way for itself. However, when the arbitration procedure is initiated, the outcome is different.

As for the unilateral adjustment, Article 5 determines that "where a Contracting State intends to adjust the profits of an enterprise in accordance with the principles set out in Article 4, it shall inform the enterprise of the intended action in due time and give it the opportunity to inform the other enterprise so as to give that other enterprise the opportunity to inform in turn the other Contracting State". The MNE whose profits are intended to be adjusted by the MS of its residence, may submit a claim to resolve the dispute under the Convention if the adjustment is likely to result in double taxation. If the case arrives that both MNEs and MS involved have been informed of the intended adjustment and agree with it, the dispute resolution method under the Convention shall not further apply. Nevertheless, it will only be considered that the second MS accepts the adjustment proposed if it makes the corresponding profit adjustments, avoiding that way double taxation[39].

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[37] BERNATH, A., *"The implications of the Arbitration Convention: A step back for the European Community or a step forward for elimination of transfer pricing related double taxation?"*, Master's Thesis, Jönköping International Business School, May 2006, p. 44- 45.

[38] Supra note 14, Articles 5-7.

[39] Supra note 37, pp.47- 48.

Otherwise, when the case is well- founded, but the competent authority cannot arrive to a proper solution by itself, cooperation within MS involved will be necessary, following a MAP [40].

Once the procedure initiated, MSs have a two years term to achieve a solution, which shows the Convention's aim of providing taxpayers with speedy dispute resolutions. But parties can waive that time limit, which has proven to lead to significant delays[41].

According to a 2012 JTPF Report, the average time for the cases to be completed widely differ amongst the EU countries: Luxembourg disputes are the most rapidly resolved, with an average of 9 months delay, while in Spain it takes 47 months for a case to be completed. According to the available data, the EU average time for a case to be completed is 31 months, but it must be taken into account that France and Germany are the countries that resolve most of the cases and do not provide data on the time it takes to do it. Also, many cases are extended by mutual agreement between the parties involved[42].

However, "if the competent authorities concerned fail to reach an agreement that eliminates the double taxation referred to in Article 6 within two years of the date on which the case was first submitted to one of the competent authorities in accordance with Article 6(1), they shall set up an advisory commission charged with delivering its opinion on the elimination of the double taxation in question"[43].

The advisory commission mentioned must give its opinion on the case in a maximum of six months from the day the matter was referred to it. Starting from that moment, MS involved have a time limit of six months to arrive at a solution, in the terms of the

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[40] Supra note 37, pp. 48-49.

[41] BANTEKAS, I., "The mutual agreement procedure and arbitration of double taxation disputes", *Anuario Colombiano de Derecho Internacional*, Nº1, 2008, p. 192, reachable at dialnet.unirioja.es/descarga/articulo/4941862.pdf (last visited 23/06/2015).

[42] EU Joint Transfer Pricing Forum, *"Statistics on Pending Mutual Agreement Procedures (MAPs) under the Arbitration Convention at the end of 2012",* December 2013, Brussels, reachable at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/jtpf/2013/jtpf_013_2013_en.pdf (last visited 23/06/2015).

[43] Supra note 13, Article 7 (1). For more details on the advisory commission constitution and membership, Article 9.

commission's opinion or not. If there is no agreement in that period of time, the indications of the commission shall be applied[44].

In this arbitration procedure, the parties involved are the MS and their corresponding tax authorities, without being the MNE affected considered as a party of the process. Still, as a third party interested in the case, it can provide documentation, information or evidence likely to be used by the commission in reaching a decision[45].

The main strength of the Convention is that it introduced the figure of arbitration as a dispute resolution method, even if limited to transfer pricing disputes. On the other hand, following a proposal from 2007, the OECD has incorporated in the Article 25 of its Model Tax Convention the possibility to use arbitration to resolve a dispute arising from the application of a tax treaty, therefore not limited to transfer pricing disputes. However, the arbitration would only be applicable if both countries signing the tax treaty agreed to do so (countries are offered the possibility to use this dispute resolution mechanism only with the States of their choice)[46].

1.2.3.2 Joint Transfer Pricing Forum

In 2001, the EC released a study on "Company Taxation in the Internal Market", highlighting the importance of transfer pricing problems for the internal market. In order to help MSs to better coordinate in the application of transfer pricing methods and to improve the AC's provisions, an expert group on transfer pricing was proposed[47].

The JTPF held its first meeting in October 2002 and the main working area was the improvement of the practical functioning of the AC. Eventually, a Code of Conduct was seen as the best option for its effective implementation[48].

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[44] Supra note 37, p. 53.

[45] Supra note 14, Article 10.1.

[46] OECD, *Improving the resolution of tax treaty disputes*, Committee of Fiscal Affairs, January 2007, pp. 4-5, reachable at http://www.oecd.org/ctp/dispute/38055311.pdf (last visited 06/07/2015).

[47] European Union, Commission Staff Working Paper SEC (2001)1681 on *"Company Taxation in the Internal Market",* 2001, Brussels, pp. 13 and 357, reachable at http://ec.europa.eu/taxation_customs/resources/documents/company_tax_study_en.pdf (last visited 15/06/2015).

[48] European Union, Decision 2006/C 176/02 of the Council of the European Union adopting a Code of conduct for the effective implementation of the Convention on the elimination of double taxation in

Throughout the years, the JTPF has provided assessment to the EC in many areas related to TP, such as Cost Contribution Arrangements, APAs within the EU, TP in the context of small and medium enterprises, secondary adjustments or risk management. However, it has continuously updated its work on the effective implementation of the AC. The last update is the revised Code of Conduct proposed in March 2015, which provides clarification in many subjects such as the application of the Convention in absence of tax payment, the functioning of the 3-year period under Article 6 or the transparency in cases where the access to the AC is denied[49].

Another relevant topic in the author's opinion has been treated by the JTPF: Transfer Pricing Risk Assessment. The final report on this topic points out that transfer pricing risk is not limited to the establishment of a non- arm's length price, but also includes the risk that resources- of enterprises and tax administrations- are not being allocated efficiently when dealing with transfer pricing issues. In order to avoid those risks, specific guidelines are given for each phase of a transfer pricing file: initial, audit and resolution[50].

1.2.3.3 Other Transfer Pricing related initiatives within the European Union

One of the most relevant tax initiatives within the EU is the Common Consolidated Corporate Tax Base (hereinafter CCCTB), proposed by the EC in 2011 as a mean to promote growth in the Internal Market and defined as "a system of common rules for computing the tax base of companies which are tax resident in the EU and of EU-located branches of third-country companies. Specifically, the common fiscal framework provides for rules to compute each company's (or branch's) individual tax results, the

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connection with the adjustment of profits of associated enterprises, *Official Journal of the European Union C-176*, 28th July 2006, pp. 8- 12, reachable at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:42006X0728(02)&from=EN (last visited 04/06/2015).

[49] EU Joint Transfer Pricing Forum, *Final Report on Improving the Functioning of the Arbitration Convention*, 12th March 2015, Brussels, reachable at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/final_report_ac_jtpf_002_2015_en_final_clean.pdf (last visited 04/06/2015).

[50]EU Joint Transfer Pricing Forum, *Report on Transfer Pricing Risk Management,* 6th June 2013, Brussels, reachable at: http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/jtpf/2013/jtpf_007_2013_en.pdf (last visited 04/06/2015).

consolidation of those results, when there are other group members, and the apportionment of the consolidated tax base to each eligible Member State"[51].

Even though initially proposed as a Directive- applicable in all MSs, due to the opposition of certain MSs like Ireland, the United Kingdom and the Netherlands, it eventually proceeded through an enhanced- cooperation agreement- applicable only in certain MSs[52].

The final version of the proposal was designed as an optional system for taxpayers who would be benefited by it, without imposing it to all MNEs operating in multiple EU MS. One of the main benefits of the CCCTB is the reduction of tax compliance costs, as studies previous to the proposal showed that the tax savings for opening a subsidiary in another MS would be of up to 60% with regard to the compliance costs under the arm's length principle. As for tax administrations, the proposal was fairly respectful with MS's tax sovereignty, because tax rates of each country are not modified under the CCCTB and nor are financial accounts[53].

However, this initiative was rather controversial, as defenders of the ALP pointed out its many limitations and weaknesses, while FA advocates saw it as a possible beginning of the global shift towards FA. The EC has continued its work on the proposal and has recently re- launched it in the context of the Action Plan for Fair and Efficient Corporate Taxation, which will be further analyzed in Part III.

2. Transfer pricing as a mechanism of tax avoidance

As we have previously remarked, transfer pricing is a regular mechanism used within associated enterprises to determine the price of intra-group transaction of goods or provision of services, which should not be immediately related to tax avoidance[54].

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[51] European Union, COM(2011) 121/4, *Proposal for a Council Directive on Common Consolidated Corporate Tax Base (CCCTB),* March 2011, Brussels, p. 5, reachable at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf (last visited 28/06/2015).

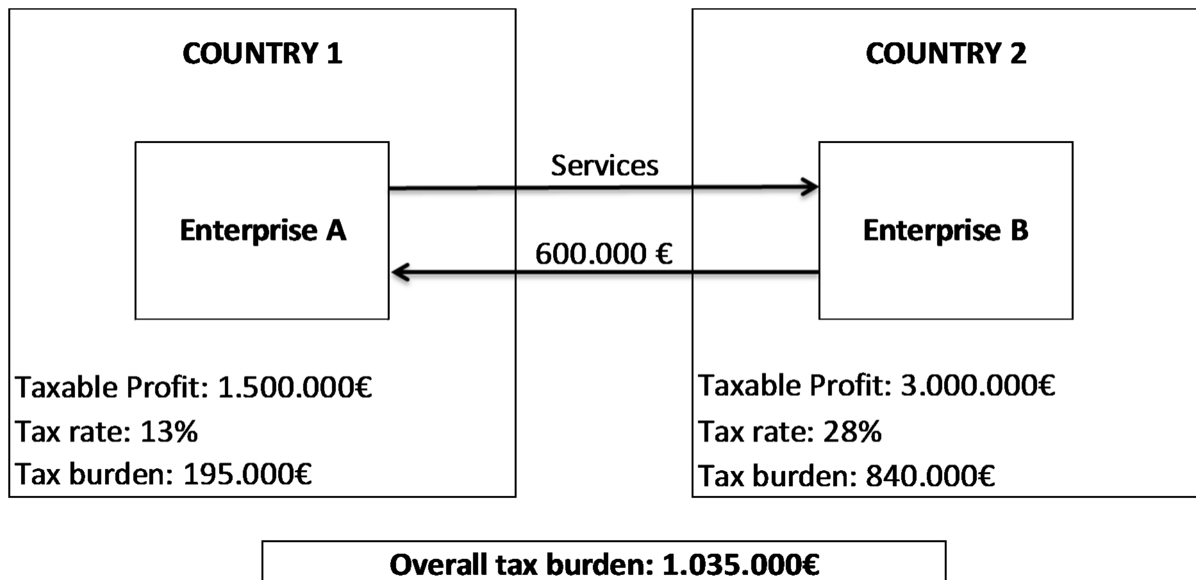
[52] Institute of International and European Affairs, *CCCTB- Dead on arrival?,* May 2011, reachable at http://www.iiea.com/blogosphere/ccctb--dead-on-arrival (last visited 06/07/2015).

[53] Supra note 51, pp. 5-6.

[54] Supra note 12, at Chapter I, para. 1.2.

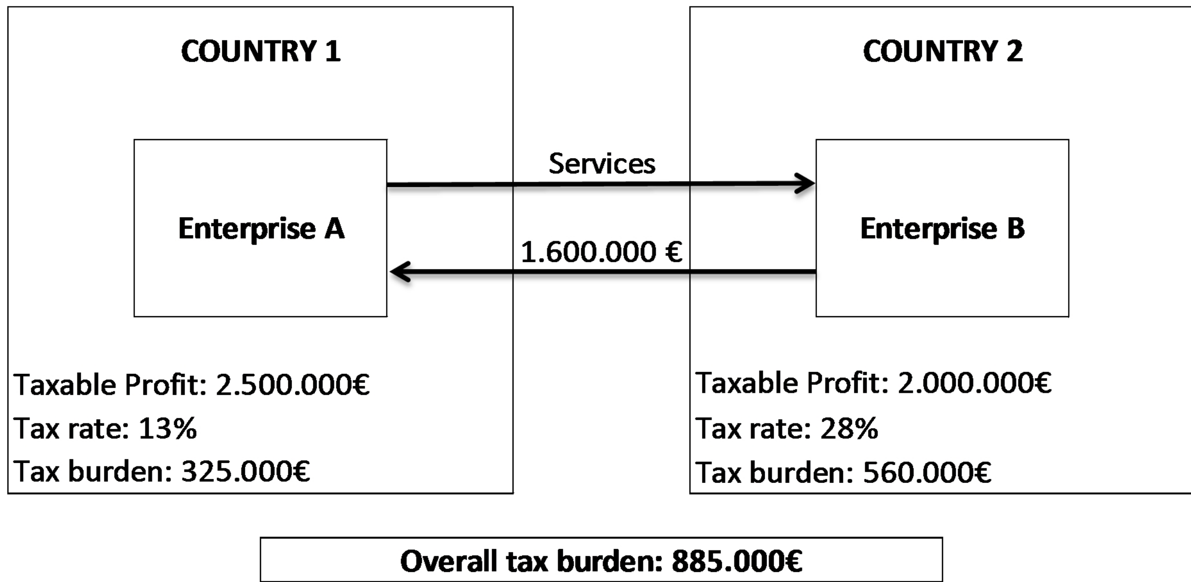
However, when transfer pricing is not set at arm's length, tax administrations may start the appropriate verifications in order to see if the mis-pricing is due to tax avoidance intentions or other causes, such as lack of comparable information. If the transactions concerned do not correspond to effective economic activity, it is likely to be in front of a profit shifting case.

Given a case in which Enterprise "A", operating in country 1, provides throughout the year services to associated Enterprise "B", operating in country 2, whose market value within independent parties is 600.000€, supposing the profit of Enterprise "A" is 1.500.000€ and tax rate in country 1 is 13%, as well as the profit of Enterprise "B" is 3.000.000€ and tax rate in country 2 is 28%, the outcome of the operation at arm's length would be as follows[55]:

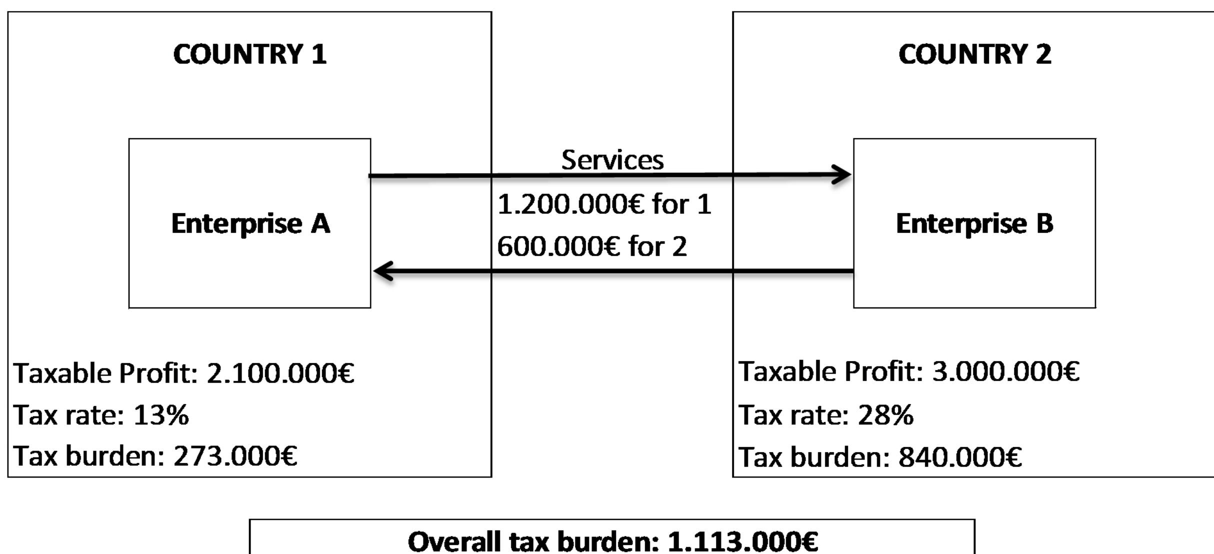


However, being "A" and "B" associated enterprises, they might set a different price for the provision of services, in order to minimize profits in country 2, which has a tax rate much higher than country 1. To do so, they set a higher price, in order to increase profits of Enterprise "A" and expenditures of Enterprise "B". For instance, if they set a price of 1.600.000€ instead of the market value, the overall tax burden would be modified as shown below:

[55] The concept *profit* makes reference to *earnings before taxes*, defined in the *OECD Glossary of Tax Terms* as it follows: "Sales revenue less cost of sales, operating expenses, and interest, before taxes have been paid".



As it can be seen, the tax savings for the MNE group, after the manipulation of the transfer pricing reach 150.000€, as the overall tax burden is 885.000€ instead of 1.035.000€. In this case, tax authorities from country 2 would be disadvantaged, as their tax revenue is being unjustifiably reduced in 180.000€. Obviously, figures showed in the example are usually much higher in reality, and tax erosion could easily reach millions of euros. Consequently, adjustments are going to be made by country 2, establishing the transfer price at arm's length, by reference to comparable transactions, which would be 600.000€. However, Country 1 might not accept those adjustments, as it would involve a tax refund towards Enterprise A. Instead, it will calculate separate adjustments, establishing for instance a transfer price of 1.200.000€. This type of disagreement within tax administrations lead to double taxations, as it is shown below:



The overall tax burden is 78.000€ higher than it should be if both countries would recognize the same transfer price for the transaction, namely the arm's length price.

We have previously seen international arbitration as a possible mechanism of dispute resolution, but it has to be pointed out that it would be applied *a posteriori.* Therefore, in order to avoid the capital and time costs involved, other solutions should be approached, such as Advance Pricing Agreements (hereinafter APA), an *a priori* mechanism defined as an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the TP for those transactions over a fixed period of time[56].

The parties involved in an APA are the associated enterprises that are going to undertake the concerned transactions and the tax authorities of the jurisdictions involved in those transactions. Even if unilateral APA- with only one tax authority involved- are possible, for the purpose of avoiding double taxation, bilateral or multilateral APAs are highly preferred, as all tax jurisdictions involved in the transaction take part to the arrangement and therefore, risk of double taxation and subsequent adjustments is fairly reduced[57].

As an example of multilateral APA, we can mention the Spanish Corporate Tax Law, which indicates at its Article 18.9 that the Spanish tax administration can reach agreements with other tax administrations, with the aim of jointly determining the transfer prices.[58] The Corporate Tax Bylaw specifies that the negotiation process for a multilateral APA can be initiated by the Spanish tax administration at the taxpayer's request[59].

During the arrangement's negotiation process, it is vital that associated enterprises collaborate with the tax authorities, by providing data on the methodology that they consider appropriate for their case, as well as documentation supporting their proposal[60]. Special attention must be paid by both parties to the assumptions and the nature of the

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[56] Supra note 13, at Chapter IV, para. 4.123.

[57] Supra note 13, at Chapter IV, para. 4.130.

[58] Law 27/2014, from November 27th 2014, on Corporate Tax, *State Official Newsletter*, November 28th 2014, nº 288, p. 96975, reachable in Spanish at http://www.boe.es/boe/dias/2014/11/28/pdfs/BOE-A-2014-12328.pdf (last visited 06/07/2015).

[59] Royal Decree 1777/2004, from July 30th, approving the Corporate Tax Bylaw, *State Official Newsletter*, August 6th 2004, last updated November 28th 2014, Article 29.4- 29.9, reachable at http://www.boe.es/buscar/pdf/2004/BOE-A-2004-14600-consolidado.pdf (last visited 06/07/2015).

[60] Supra note 13, at Chapter IV, para. 4.133.

predictions on which the terms of the agreement are settled, as its reliability might be affected if the assumptions aren't reasonable or the predictions fail[61].

One of the main advantages of APAs is the elimination of uncertainty for taxpayers, as tax treatment in international transactions becomes predictable[62]. This might acquire high importance in developing countries economically attractive, but politically and legally unstable, like India.

This country started an APA program in March 2013, in order to reduce its TP disputes and litigation. During the first year, 146 applications for unilateral APAs were received and 5 of them were agreed on before March 2014[63]. For now, applications are still mainly for unilateral APAs, but the first bilateral APA has already been signed in December 2014 with Japan and many others are being negotiated also with the USA[64]. Tax officials from India and USA have held multiple formal meetings in order to establish a framework for resolving double taxation due to transfer pricing issues, among others. The ongoing negotiations for bilateral APAs concern mainly IT Software Development and IT enabled services corporations[65].

However, in order to remain efficient, an APA must be flexible, able to adapt to changing market conditions and other differences that may arise in the business structure of the concerned MNE[66].

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[61] Supra note 13, at Chapter IV, para. 4.125- 4.129.

[62] Supra note 13, at Chapter IV, para. 4.142.

[63] ERNST&YOUNG INDIA (2014), *"India Advance Pricing Agreements: providing transfer pricing certainty",* available at http://www.ey.com/Publication/vwLUAssets/EY-India-Advance-Pricing-Agreements/$FILE/EY-India-Advance-Pricing-Agreements-providing-transfer-pricing-certainty.pdf (last visited 11/06/2015).

[64] SRIVATS, K.R. (April 3, 2015), "CBDT signs 3 more unilateral APAs", *The Hindu Business Line*, available at http://www.thehindubusinessline.com/economy/cbdt-signs-3-more-advance-pricing-agreements/article7065018.ece (last visited 11/06/2015).

[65] ERNST&YOUNG (2015), *"US and India Tax Authorities agree on framework for resolving certain double tax cases"*, available at http://www.ey.com/Publication/vwLUAssets/US_and_India_Tax_Authorities_agree_on_framework_for_resolving_certain_double_tax_cases/$FILE/2015G_CM5155_TP_US%20and%20India%20TA%20agree%20on%20framework%20for%20resolving%20certain%20double%20tax%20cases.pdf (last visited 11/06/2015).

[66] Supra note 13, at Chapter IV, para. 4.148 and 4.149.

The international guidelines on transfer pricing, previously seen, offer a variety of tools and methods to avoid transfer pricing being used as a mechanism of tax avoidance. However, there are still many questions without convincing answers and international integrated efforts are needed in order to prevent tax avoidance in this field.

3. Transfer pricing problems and challenges

As it has been observed in the previous paragraph, MNE can use transfer pricing for manipulating their tax base in the countries in which they have their business located, in order to minimize the effective tax burden. The application of the current rules might sometimes require significant time and capital costs of the parties involved, but the main problem is that TP is being the major tool for corporate tax avoidance[67].

The author considers important to mention here that tax avoidance by the means of TP is not specifically located in certain areas of the world, as it has been proven by the multiple cases that have arisen in different countries, both developing and developed.

As for developing countries, China might be the best option to analyze, as its huge economic growth in the last decades, along with tax incentives, have increased the number of MNE operating in the country. Foreign direct investment in the country has augmented from $3,4 billion in 1990 to $128,5 billion in 2014[68].

It is surprising that from 1996 to 2005, between 55% and 65% of foreign investors in China claimed to be making losses in the country, but did not withdraw their investment from the country. Quite the opposite, foreign investment kept increasing[69].

[67] PAPAPANAGIOTOU, M., *"International Tax Avoidance: Business Structures and Ethicsmore"*, p. 6, reachable at https://www.academia.edu/6743295/International_Tax_Avoidance_Business_Structures_and_Ethics (last visited 24/06/2015).

[68] UNCTAD, *"World Investment Report 2014"*, 2014, New York and Geneva, Annex Table 1, reachable at http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx (last visited 24/06/2015).

[69] SIKKA, P. and WILMOTT, H., "The Dark Side of Transfer Pricing: its Role in Tax Avoidance and Wealth Retentiveness", *Critical Perspectives on Accounting*, 21(4), April 2010, p. 351.

Chinese Tax Administrations started taking measures, as many studies revealed that 60% of tax avoidance was due to transfer pricing arrangements, mainly mispricing of exports towards MNEs' subsidiaries in Hong Kong[70].

This being the case, income tax law was modified, giving the same treatment to foreign and domestic enterprises. Also, tax incentives previously granted to foreign investors were withdrawn[71]. After that significant change in tax law, the number of TP cases significantly decreased and tax revenue increased[72].

As for developed countries, we could mention many cases that have been solved or are under investigation in the EU. One of the most sounded has been the Starbucks case in the Netherlands: the EC argues that the APA agreed for Starbucks Manufacturing BV in 2008 might constitute aid state, forbidden in the Articles 107 and 108 of the TFEU[73]. Mainly, the EC has three doubts about the APA's compliance with the ALP.

The first query would be whether the Netherlands acted correctly when accepting the company's low-risk toll manufacturer condition, given the functions it performs within the group[74].

Secondly, given the accepted low- risk toll manufacturer condition of the company, adjustments needed to be made to its cost base, but the EC has doubts about the appropriateness of the two adjustments presented by the company's tax advisor, as the first one considered that functions performed by the company other than manufacturing,

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[70] The State Council of the People's Republic of China, (2005). *Shenzen city nabs multinational tax evaders*, reachable at: http://www.gov.cn/english//////////////////2005-12/31/content_143759.htm (last visited 25/06/2015).

[71] CHRISTINA Y.M. NG, "The New Transfer Pricing Rules and Regulations in China— Impact on Foreign Investors", *International Tax Journal*, March- April 2010, p. 50, reachable at http://apps.osgoode.yorku.ca/Quickplace/jinyanli/PageLibrary852574DA004EB5B7.nsf/0/80A64EA502D1A951852578D20081BB5B/$file/The%20New%20Transfer%20Pricing%20Rules%20and%20Regulations%20in%20China%20-%20Impact%20on%20Foreign%20Investors.pdf (last visited 25/06/2015).

[72] Supra note 69, p. 352.

[73] European Union, Consolidated Version of the Treaty of the Functioning of the European Union, *Official Journal of the European Union C326*, pp. 91-93, reachable at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN (last visited 25/06/2015).

[74] European Commission, Letter to Netherlands about Alleged Aid to Starbucks, June 11th 2014, Brussels, p. 28, reachable at http://ec.europa.eu/competition/state_aid/cases/253201/253201_1596706_60_2.pdf (last visited 25/06/2015).

such as distribution or sales, shouldn't be remunerated. As for the second adjustment, it is suspicious that instead of estimating the remuneration of raw materials by reference to comparables, it does it by reference to the EURIBOR interest rate, with a 0,5 mark-up, without additional justification[75].

In third place, the major doubt of the EC is the system followed to value the royalties due by the company to Alki LP, as their value depended on the difference between the accounting pre-tax profit before the payment and the remuneration under the APA (sales minus raw materials cost, minus operating and other costs), with no reference to the Intellectual Property's value. In addition, this way, the accounting profit before tax was assured to be always equal to the remuneration established in the APA. As a consequence, the royalties' value fluctuates from year to year, but not in line with sales[76].

The EC is still investigating the case, which is expected to be closed in 2016. Meanwhile, new information about it arises in the press, such as the fact that Alki LP has been dissolved, but during its activity it appeared to have no employees, no accounts filed and it was registered at the offices of Starbuck's tax lawyers in London[77]. All this facts, if proven to be true, raise a serious question about the company's compliance with international tax rules.

As it can be seen, problems may arise from different elements of TP. Currently, in the author's opinion, the main challenges that need to be faced are the valuation of intangibles and the specific problems that may arise from the application of TP rules in developing countries.

Regarding intangibles, the most relevant issue is their valuation when transferred within related parties, as they usually involve unique intangibles that would not be transacted between independent parties and therefore the application of the ALP is complicated as there are few or no comparable transactions[78].

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[75] Ibidem, pp. 32-33.

[76] Ibidem, pp. 35-37.

[77] CAMPBELL, P., "Starbucks used UK firm to cut European tax bill: coffee chain under investigation after using company to hide millions from Dutch authorities". *The Daily Mail Online*, April 7th 2015, reachable at http://www.dailymail.co.uk/news/article-3029602/Starbucks-used-UK-firm-cut-European-tax-bill-Coffee-chain-investigation-using-company-hide-millions-Dutch-authorities.html (last visited 25/06/2015).

[78] FINAN, W. F. and LAUNIAU, S., "Valuation of Intangibles for Transfer Pricing Purposes: Convergence of Valuatios for Transfer Pricing Purposes with Valuation for Other Purposes", Working Party No. 6 of

With respect to developing countries, there are many problems arising: national tax law in many countries needs to be adapted for international TP rules, professionals need to be trained in specific TP areas, compliance costs tend to be too high for taxpayers to support and public resources are limited and need to be strategically employed. In this context, exchange of information becomes crucial for these countries[79].

In the latest years, many projects have been launched by international organizations regarding these TP challenges. Most of them focus on the improvement of the existing system, based on the ALP[80]. However, it is a critical moment to wonder if, given the current and expected trends in global trade and business structure, the ALP approach will still be able to effectively deal with TP problems or whether the adoption of a new approach, namely FA, would be advisable.

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the Committee on Fiscal Affairs, March 23rd 2011, p. 2, Reachable at http://www.oecd.org/ctp/transfer-pricing/47429988.pdf (last visited 28/06/2015).

[79]OECD, *Dealing Effectively with the Challenges of Transfer Pricing*, OECD Publishing. Paris, 2012, pp. 69- 71, reachable at *http://dx.doi.org/10.1787/9789264169463-en* (last visited 27/06/2015).

[80] Supra note 16.

II. INTERNATIONALLY ACCEPTED APPROACH: THE ARM'S LENGTH PRINCIPLE

The origins of the ALP, as an international approach, should be sought after the First World War, when cross-border trade and taxes increased and double taxation became critical. The League of Nations approached the issue from a financial, economic and fiscal outlook, through the creation of experts' commissions.

One of the experts was Mitchell B. Carroll, an adviser to the US Treasury, who seems to be the father of the ALP, as the first draft of the current ALP could be seen in one of his reports for the Fiscal Committee of the League of Nations. Following those findings, the Committee drafted a multilateral treaty on the allocation of business profit and the approach got more specific, being later adopted by the OECD at the Article 7 of its Model Convention in 1963 and gradually accepted by the international community[81].

It could be said that the international consolidation of the ALP arrived with the OECD 1979 Report, which dedicated its first Chapter to the definition of the approach and the following four chapters to specific rules for its application for goods, intangible property, services and loans[82].

The 2010 OECD Guidelines on TP also adopt the ALP, stating that it provides the closest outcome to the open market operations, even if its application may result complicated in some cases. Also, it specifies the main factors that must be taken into account when determining comparability within related and unrelated transactions: the characteristics of the property or services transferred, the functions performed by the parties, the contractual terms, the economic circumstances of the parties and the business strategies pursued by each party[83].

1. Transfer pricing methods under the arm's length principle

The 2010 OECD Guidelines indicate and recognize, along with the three traditional methods- focused on the transaction-, the appropriateness of other two methods, based on

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[81] HAMAEKERS, H., "Arm's Length- How Long?", *International Transfer Pricing Journal,* March/April 2001, p. 32-33.

[82] WITTENDORFF, J., "Transfer Pricing and the Arm's Length Principle in International Tax Law", 2010, The Netherlands, Kluwer Law International BV, p. 100.

[83] Supra note 13, at Chapter I, para. 1.14- 1.37.

profit analysis, to establish an arm's length price for controlled transactions. Therefore, a total of five methods for determining the arm's length price between related parties are available. Depending on the circumstances of the case, one of them will usually be more suitable than the others, as it will be seen below.

1.1 Traditional transaction methods

1.1.1 Comparable uncontrolled price method

Under the comparable uncontrolled price method (hereinafter CUPM), the price of a transaction within related parties is considered to be set at arm's length when it is equal to the price set in a transaction within independent parties, which is considered to be a comparable transaction. However, in order to consider the transaction involving independent parties as comparable, there cannot be any differences between the transactions or the enterprises involved that may have material effects on the price set in the open market. Also, if those differences exist, the transaction is still comparable if reasonably accurate adjustments can be made to eliminate their effects[84].

According to the UN, reasonably accurate adjustments under this method may be applied if the differences raised affect the type and quality of the products, the delivery terms, the volume of sales and related discounts, the product characteristics, the contractual terms, the risks incurred or general geographical factors. However, the adjustments might be impossible if the differences within the products are fundamental or if one of them is linked to a trademark, as the effect it has on the price cannot be certainly determined[85].

Being the most direct way of applying the ALP, the OECD considers this as the most reliable method and therefore, it should always be preferred above the others if data on comparable transactions is available[86]. Following this statement, the UN thinks that an examiner should consider this method as a first option and it highlights that the existence of internal comparable (the uncontrolled transactions that one of the related parties from the controlled transaction might have recently been involved in) would help identifying

[84] Supra note 13, at Chapter II, para. 2.13- 2.15.

[85] Supra note 7, at Chapter VI, para 6.2.2.5 and 6.2.2.6.

[86] Supra note 13, at Chapter II, para. 2.14.

the material differences within controlled and uncontrolled transactions and so the adjustments needed would be more reliable[87].

Taking as example enterprise AA, a French TV manufacturer that sells its products to a controlled distributor in Paris (enterprise AB) and to an uncontrolled distributor in Berlin (enterprise BB), if the geographic difference is the only one between the set of transactions, the price for the controlled transactions can be settled by comparison to the prices set for the transactions within AA and BB,. Supposing that the distributor sells the product to BB at 450€/unit, plus delivery costs of 0,05€/km, if AA is based in Lyon, the prices would be as follows:

	TV Price/ unit	Distance (kms)	Delivery costs/km	Total Delivery Costs/ Unit	Total Price/unit
BB (Berlin)	450,00 €	975	0,05 €	48,75 €	**498,75 €**
AB (Paris)	450,00 €	392	0,05 €	19,60 €	**469,60 €**

Consequently, the arm's length price under the CUPM for the transactions between AA and AB, given the price charged by AA to BB, would be as shown in the table above. However, this comparison could not be done if the products sold to AB and BB were different.

1.1.2 Resale price method

The starting point for determining the arm's length price of a controlled transaction under this method- the resale price method (hereinafter RPM)-, is the resale price at which the buyer on the controlled transaction is going to resell the product to an independent company. That price must be reduced by a gross profit margin and other costs associated to the purchase[88].

Therefore, the critical element for applying this method is the gross profit margin that the sales company will retain in order to cover its costs and still make a certain profit level, which will depend on the functions performed and the risks assumed by the company buying and selling the item[89]. In order to determine the appropriate resale price margin, internal and external comparable will be used in order to determine that margin, as it has

[87] Supra note 7, at Chapter VI, para. 6.2.4.1- 6.2.4.4.

[88] Supra note 13, at Chapter II, para. 2.21.

[89] Supra note 7, at Chapter VI, para. 6.2.6.2.

to be similar to the one that the same company applies in comparable uncontrolled transactions[90].

It must be mentioned here that in order to consider gross profit margins comparable, there must be no difference between the transactions or the enterprises involved that could materially affect the resale price margin and if there is any, reasonably accurate adjustments should be possible in order to eliminate those differences. Also, accounting consistency is extremely important, as different approaches might have great impact on the gross profit of the company. For instance, if the costs structure or the inventory valuation methods aren't the same in both companies that are being compared, their gross profit margins cannot be considered as comparable without making the proper adjustments[91].

Along the comparability analysis, under the RPM, product differences are likely to have less impact on the gross profit than on the price, so fewer adjustments on that aspect are needed than under the CUPM. However, the other comparability factors have to be closer analyzed, such as the functions performed, the economic circumstances or the business strategies. For instance, if the buyer doesn't perform much commercial activity before selling the product, its margin will probably be lower than if it does. Also, it has to be taken into account that this method might be too difficult to apply in cases where the buyer ads substantial value to the product before selling it, especially if it involves intangibles[92].

Given the case of enterprise R, which sells mattresses and has two suppliers, namely enterprise 1 (parent company) and enterprise 2 (independent company), considering that the functions performed are substantially similar in both set of transactions and that the accounts of all three enterprises are consistent, the price of the sales operation between 1 and R can be calculated by reference to the sales operation between 2 and R. Therefore, if R buys mattresses from 2 for 100€/unit and sells them for 130€/unit, the gross profit margin it applies is 30%. So, if the enterprise sells the mattresses bought from 1 for 110€/unit (lower quality), the arm's length price under RPM for the purchase from 1 would be as follows:

[90] Supra note 13, at Chapter II, para. 2.22.

[91] Supra note 7, at Chapter VI, para. 6.2.7.2.

[92] Supra note 13, at Chapter II, para.2.28-2.35.

110€/unit- (110€/unit*30%) = 110€/unit- 33€/unit = **77€/unit**

1.1.3 Cost plus method

In a similar way to the RPM, the cost plus method (hereinafter CPM), determines the arm's length price of a controlled transaction by applying a gross profit margin. However, the approach is different: the starting point for the CPM are the costs incurred by the supplier for the production of the goods or services transferred to an associated enterprise. The OECD considers that the proper arm's length price is obtained by adding to those costs an appropriate cost plus mark up, which allows the supplier to obtain a proper profit, depending on the functions performed and the market conditions. It is preferable for the cost plus mark up to be determined by reference to an internal comparable, although external are also accepted[93].

In order to consider two transactions comparable under this method, there must be no differences between the transactions themselves or between the companies that could have material effects on the cost mark up, or if those differences exist, reasonably accurate adjustments must be applied to eliminate them. As it occurs under the RPM, functional comparability is more important than product comparability, but still the outcome is more reliable if the products are similar[94].

Accounting consistency is once again extremely important when applying the CPM, but the determination of costs also becomes crucial: it is essential that a comparable mark up is applied to a comparable cost basis. Therefore, attention should be paid to the types and level of expenses, along with the functions performed and the risks assumed. When differences arise in those aspects (as for example, if one enterprise uses leased business assets and the comparable owns its business assets), the OECD establishes the type of adjustments that must be applied, depending on the effect that those differences have on the transactions being compared[95].

Taking the example used for the RPM, if enterprise 1 supplies single bed mattresses to enterprise R (subsidiary) and double bed mattresses to enterprise S (independent company), depending on the production costs of every mattress and on the sales price for

[93] Supra note 13, at Chapter II para. 2.39 and 2.40.

[94] Supra note 7, at Chapter VI, para 6.2.17.1- 6.2.17.2.

[95] Supra note 13, at Chapter II, para. 2.43- 2.46.

S, the sales price for R can be calculated. Therefore, if the production costs for double bed mattresses are 50€/unit and they are sold to S for 60€/unit, the gross profit margin is 20%.

Being the production costs for single bed mattresses 35€/unit, the price that should be settled between 1 and R should be calculated as shown below:

35€/unit+ (35€/unit*20%) = 35€/unit+7,5€/unit= **42,5€/unit**

1.2 Transactional profit methods

Following "the most appropriate method" principle established in the OECD Guidelines, it is indicated that there are situations in which profit based methods are more reliable than the traditional transaction methods. As the transactional profit methods use the profit arising from a controlled transaction as a relevant indicator of whether the conditions of the transaction were set at arm's length, their application is advisable in cases where the parties engage in highly integrated activities, where there is no comparability data available for applying one of the traditional methods or where each party makes valuable and unique contributions[96].

The UN specifies that their application is recommended when intangibles are involved in the controlled transaction and their appropriate return must be determined[97].

1.2.1 Transactional net margin method

The transactional net margin method (hereinafter TNMM) analyses, regarding an appropriate base, the net profit obtained by a taxpayer from a controlled transaction. It is a one-sided method that operates in a similar way to RPM and CPM and therefore should be applied following the same general comparability rules: the net profit indicator of the enterprise involved in the controlled transaction must be determined by reference to the net profit earned by the same taxpayer in comparable uncontrolled transactions[98].

As net margins are less affected by product or functions differences, product and function comparability are less relevant under this method than under the traditional transaction methods when determining comparability. In return, there are many other factors, mainly

[96] Supra note 13, at Chapter II, para.2.4.

[97] Supra note 7, at Chapter VI, para. 6.3.1.2.

[98] Supra note 13, at Chapter II, para. 2.58.

market based, that affect a company's profitability, such as barriers to entry in the industry, the threat of substitute products, the company's competitive position, the management efficiency and the degree of business experience. These elements must be taken into account when selecting the comparable uncontrolled transaction, applying reasonably accurate adjustments when differences that may arise have a material effect on net margin[99].

As indicated above, the company's profit must be analysed and compared under a certain profit indicator that must be selected depending on the circumstances of the case, taking into account the appropriateness of the indicator in view of the transaction's nature, the availability of reliable information and the degree of comparability between controlled and uncontrolled transactions[100].

Depending on the company's business sector, the reliability and appropriateness of a profit indicator may vary. The OECD indicates that profit indicators related to sales or distribution operating expenses could be an appropriate base for distribution activities, others related to full costs or operating expenses for a service or manufacturing activity and the ones taking into account operating assets for capital- intensive activities[101]. Meanwhile, the UN points out that the profit indicators most used in practice are Operating Margin for marketing, sales and distribution activities, Return on Capital Employed and Return on Assets for manufacturing activities and Return on Total Costs, without specifying a business sector for this last indicator[102]. Hence, it can be affirmed that both organizations reach the same conclusions on this issue, but the UN is more specific from an accounting point of view.

One of the main problems posed by this method is the measurement of the net profit when an enterprise has different business activities: it may be difficult to allocate sales revenue, operating expenses or assets so that net profit indicators can be separately calculated for the relevant business being compared and the other activities of the enterprise. However, its application is advisable when comparability data isn't available for traditional

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[99] Supra note 7, at Chapter VI, para. 6.3.9.2- 6.3.9.3.

[100] Supra note 13, at Chapter II, para. 2.76.

[101] Supra note 13, at Chapter II, para. 2.87.

[102] Supra note 7, at Chapter VI, para. 6.3.7.1- 6.3.7.3.

transaction method to be applied or in the cases where one of the parties of the transaction contributes intangible assets[103].

Given the example of enterprise W, operating in a country in the distribution area, providing services to its parent company (U) and an independent company (O), the price for the transactions within the related parties can be determined by reference to the price of the transactions within W and O. In this case, O's competitive position reduces W's Operating Margin in 1,5%. Therefore, given the fact that W provides a storage service for both U and O and that the Operating Margin of the services provided for O are 2%, the net margin of the services provided for the parent company U should be 3,5%, as the latter doesn't have the competitive position that O does.

1.2.2 Transactional profit split method

This method aims to eliminate the effect that have on profits the special conditions made or imposed in a controlled transaction. To do so, it determines a division of profits that independent enterprises would have expected to obtain from engaging in the transaction.[104] After determining the profits to be divided between the involved associated enterprises, the division is established by reference to external comparable if available. If it is not, the split must be done by reference to each side's contribution, taking into account the functions performed, the risks assumed and the assets used. Usually, this method is applied in transactions whose both parties contribute significant intangible property[105].

There are two approaches for apportioning the profits, depending on the circumstances of the case: contribution analysis and residual analysis. The first of them highly depends on external comparable, as the division should be done by reference to the profit split between independent enterprises engaged in comparable transactions. In the absence of external comparable, the distribution is based on the value of the functions performed by each party, which can be difficult to determine.

[103] Supra note 7, at Chapter VI, para. 6.3.11.2.

[104] Supra note 13, at Chapter II, para. 2.108.

[105] Supra note 7, at Chapter VI, para. 6.3.13.1- 6.3.13.3.

As for the residual analysis, it is a two steps approach: in a first stage, the profit attributable to non-unique contributions is split between the parties, usually following one of the traditional transactional methods or the transactional net margin method, by reference to uncontrolled comparable transactions and in a second stage, the possibly residual profit is split among the enterprises depending on the analysis of the facts and circumstances[106].

The residual profit split method is used more in practice, because it presents two main advantages faced to the contribution approach: it solves the complicated problem of transfer pricing in two steps (a first division of routine profits and a second split of profits from unique contributions), making the process easier for taxpayers, and it reduces the risk of conflict with tax authorities, as the profit to be split in the second step, usually more controversial as it is due to unique contributions, is reduced[107].

As for the residual approach, an example could better illustrate the methodology. Given the case of two related companies, M and N, where M manufacturers electronic components using high- technology machinery and N buys the components to manufacture electronic products, using innovative technological design, the transfer price can be calculated as follows. Company M sells to company N components for the manufacturing of a new tablet, with additional functions. In the open market, uncontrolled comparable can be found, where independent enterprises transact similar components, but without the technology needed for the additional functions.

The profit of those transactions is 1000€, divided between the manufacturer and the buyer: 600€ for the manufacturer and 400€ for the buyer. Supposing that M and N develop the same functions and assume the same risks as the enterprises involved in the uncontrolled comparable, if the profit arising from the transaction between them gives a profit of 1300€, in the first step of the residual approach M will obtain 600€ and N will gain 400€.

The remaining 300€ (1300€-1000€) will be divided between them depending on their investments on Research and Development. Therefore, supposing M has 2000€ R&D investments, while N only has 1000€, the first one will be assigned an additional profit of

[106] Supra note 13, at Chapter II, para. 2.118- 2.121.

[107] Supra note 7, at Chapter VI, para. 6.3.14.17.

200€, obtaining a total of 800€, while the latter will only receive another 100€, gaining a total of 500€.

As the main strengths of this method, we can mention on one hand the fact that it is a two-sided method, offering a found solution for highly integrated operations and cases where both sides of the transaction make valuable unique contributions[108]. On the other hand, it also allows taking into account profits arising from economies of scale (cost advantages due, among others, to size and scale of operation)[109].

Nevertheless, a considerable weakness arises: the method highly depends on the availability for both taxpayers and tax authorities of the information from foreign affiliates, in order to measure revenue and costs for both sides of the transaction[110].

2. General advantages and disadvantages of the arm's length principle

The international standard for TP during the last decades has been the ALP, strongly defended by the OECD. The main reason for maintaining the approach are the fact that it gives a similar tax treatment to all taxpayers- whether they transact with related or independent enterprises- and the fact that it has proven to work in the vast majority of cases[111].

However, tax specialists now wonder if those arguments are still sound enough to stick to the method. Mainly, because it doesn't seem logical to treat enterprises of the same group as if they were independent parties: the nature of MNEs is precisely to act worldwide as an entity and that way, gain competitive advantages[112]. Therefore, in the author's opinion, it is self- contradictory that tax administrations, on one hand promote global trade, through free movement of capital and work and on the other hand, they cut off the advantages that MNEs obtain through international expansion.

As noted in previous paragraphs, another important disadvantage of the ALP standard is the administrative and compliance burden it creates for tax authorities and taxpayers, respectively. Due to the fact that there is no hierarchy between the five methods specified,

[108] Supra note 13, at Chapter II, para. 2.109.

[109] Supra note 7, at Chapter VI, para. 3.16.1.

[110] Supra note 13, at Chapter II, para. 2.114.

[111] Supra note 13, at Chapter I, para. 1.8- 1.10.

[112] Supra note 81, p. 34.

when engaging in a new transaction there is a need to analyze the applicability of each one of them in that specific case, in order to select the one that gives the most reliable measure of an ALP. This analysis will require quality and up to date comparables for all the indicators needed for each method. Therefore, MNEs must employ resources to obtain that data, but enterprises engaging in transactions with independent parties do not have to do all that capital and time costing work[113]. Accordingly, one may wonder if the equality principle, laying at the core of the ALP to the OECD, is being respected from this point of view.

Dependence on the availability of uncontrolled comparable transactions' data is one other essential downside, clearly noted by the UN, as it is mentioned as a weakness of all five TP methods[114].

In the next two sections discussions will be focused on the difficulties that arise from the application of the ALP to intangibles' valuation and in developing countries.

3. Arm's length principle applied to intangibles

As David Tillinghast once expressed, "*the existing body of international tax rules, as reflected both in national law and in treaties, is based in large part on the supposition that international trade consists of the physical shipment of tangible goods or the physical movement of persons to perform services at different locations. The challenge posed by the development of the Internet and related means of communication is that in many cases this is simply no longer true*"[115].

Technology has developed over the last decades and while it has changed the business structures of existing companies, it has also given place to the rise of new technological

[113] Supra note 17, pp. 34- 35.

[114] Supra note 7, at Chapter VI. When analyzing the transfer pricing methods, the UN mentions the strengths and weaknesses of each one of them.

[115] TILLINGHAST, David R., "The impact of the Internet in the Taxation of International Transactions", 50 *Bulletin for International Fiscal Documentation* 11/12 (1996), p. 524.

enterprises, where production is no longer merely material and information and intangibles have a greater role in the company's competitiveness[116].

In the 2015 Top 10 of the most valuable brands, there are six technological companies, three of them making the Top 3: Apple, Microsoft and Google. The value of those three brands arises to the incredible sum of $280.2 billion[117]. Therefore, given the economic importance they have, one may wonder how those brands are valuated, specifically for TP and tax purposes.

3.1 Definition and types of intangibles

When defining intangibles in the context of TP, the OECD insists that accounting and legal considerations should stay into the background, keeping at the forefront the conditions that would be agreed upon within independent parties. In these conditions, intangibles are referred to as *"something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances"*[118].

Given the relevance of intangibles for TP, many categories of them are defined, but only the most common are mentioned below.

Patents are considered to be legal instruments that give an exclusive right to their owner to use a given invention for a limited period of time within a specific geography. There are cases in which the research and development needed to obtain the invention involve high costs and there are others where low expenditures lead to highly valuable patentable inventions[119].

Know-how and trade secrets are information or knowledge that assist or improve the company's commercial activity. In this case, they are not protected under register, as they

[116] ÁLVAREZ, C. V., "Towards a new model for evaluation of intangibles", *Centre for Reputation Leadership*, 2011, p. 2, reachable at http://www.corporateexcellence.org/index.php/eng/Sharing-Knowledge/Towards-a-New-Model-of-Evaluation-of-Intangibles (last visited 30/06/2015).

[117] Forbes, *The World's Most Valuable Brands*, 2015, reachable at http://www.forbes.com/powerful-brands/ (las visited 30/06/2015).

[118] Supra note 24, at para. 6.6.

[119] Supra note 24, at para. 6.19.

generally consist of undisclosed information arising from previous experience, with practical application in the operation of the enterprise. The value of a know-how or trade secret highly depends on the ability of the enterprise to preserve its confidentiality[120].

Marketing intangibles are also defined. Firstly, *trademark* is said to be a unique name, symbol, logo or picture that the owner may use to distinguish its products or services from those of its competitors[121]. A *trade name* is often the same name of the enterprise, used for market penetration and recognition of the enterprise[122]. As for the *brand*, it is usually a combination of different intangibles, such as trademark, reputational characteristics or customer relationships, having a social and commercial significance[123].

Goodwill is a type of intangible referred to in various contexts. It is sometimes described as the future economic benefits associated with business assets that are not individually identified and separately recognized. In some contexts it is referred to as the expectation of future trade from existing customers. Also, it can be the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets[124].

3.2 Intangibles valuation under the arm's length principle

Given the unique nature of most intangibles transferred within related parties, their valuation is of high importance for transfer pricing, but in lack of possible comparables, it becomes extremely difficult to apply the methods under the ALP[125].

In the author's opinion, this is one of the current major problems in international taxation. Intangibles are currently being used by companies to differentiate themselves from their competitors, through a better image, better products, better services or higher quality. Taking the example of a patent registered by a parent company, when it grants the use of

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[120] Supra note 24, para. 6.20.

[121] Supra note 24, at para. 6.21.

[122] Supra note 24, at para. 6.22.

[123] Supra note 24, para. 6.23.

[124] Supra note 24, para. 6.27.

[125]OECD, *BEPS Action 8 Discussion Draft on arm's length pricing of intangibles when valuation is highly uncertain at the time of the transaction and special considerations for hard-to-value intangibles*, June 2015, Paris, p. 3 at para.1, reachable at http://www.oecd.org/ctp/transfer-pricing/discussion-draft-beps-action-8-hard-to-value-intangibles.pdf (last visited 27/06/2015).

the patent to a subsidiary, current TP rules would expect the firm to value that lease by reference to a comparable, but there will probably be no comparable, because the main characteristic of a patent is that it is protected from being used by other enterprises.

As for the OECD, the TP methods applicable to transactions involving intangibles are the same as in the general case. However, it is provided that there are some characteristics that must be taken into account when determining comparability of intangibles, namely the exclusivity it carries with, the extent and duration of legal protection, the geographic scope, its useful life, its stage of development and the expected future benefits[126].

Due to the difficulties finding comparables for intangibles, the Profit Split might be the best method, as it considers the functions performed, the risks assumed and the assets used by each party of the transaction[127].

Intangibles are considered as hard to value when at the moment of the transaction there are no reliable comparables and there is no reliable estimation of the future cash-flows or income that the intangible might create[128]. In those cases, if the income generated by the intangible is significantly different from the prospections made by the parties at the time of the transactions and if the difference is due to events foreseeable at the time of the transaction, tax administrations might apply pricing adjustments[129].

The BEPS Monitoring Group considers that further guidance should be more specific, for example by indicating what *significant difference* means, establishing a percentage limit or an absolute amount[130].

Anyways, this is one of the most confusing topics approached through the BEPS Project, as the specific guidance for intangibles valuation is not as specific as needed and taxpayers are faced with high uncertainty about pricing adjustments. In the author's opinion, it is very difficult to propose a solution for intangibles without departing from ALP.

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[126] Supra note 24, para. 6.115- 6.124.

[127] Supra note 24, para. 6.146.

[128] Supra note 125, at p. 4-5, at para. 9.

[129] Supra note 125, at p. 7, para. 11- 14.

[130]OECD, Comments on Discussion Draft BEPS Action Plan 8: Hard to Value Intangibles, 2015, p. 27, reachable at http://www.oecd.org/ctp/transfer-pricing/public-comments-beps-action-8-hard-to-value-intangibles.pdf (last visited 27/06/2015).

4. Problems arising from arm's length application in developing countries

In recent years, developing countries have had a higher growth rate than developed economies, especially from 2000 onwards thank to trade liberalization, which positively influences growth because it improves resources allocation through specialization, attracts foreign investment and allows local enterprises to operate abroad and therefore, exploit economies of scale[131].

But the rising of new economies has increased competition within countries to attract capital, with tax incentives being within the most common means. The UN points out that trade, along with transfer mispricing have become the most common tax avoidance tools in developing countries[132].

The most important issues arising when dealing with TP in these countries are going to be reviewed and special attention will be given to the Brazil case, for its relevance as a possible role model for other countries.

4.1 Data unavailability on uncontrolled comparable situations

In March 2014, the OECD released a paper on *"Transfer Pricing Comparability Data and Developing Countries"* in which it confirmed that in some developing countries it might become extremely difficult to find reliable information to apply the ALP, mainly for three reasons: there are fewer enterprises operating in one specific business sector than in developed economies, comparable information might not exist and when it does it is likely to be incomplete or in a form difficult to analyze and at last, there might be many new business activities in the country and in those cases, comparables cannot be found[133].

The document proposed four solutions for those obstacles, namely to expand access to data sources, to promote a more effective use of data sources, to propose new approaches

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[131] World Trade Organization, *World Trade Report: Trade and development, recent trends and the role of the WTO*, 2014, Geneva, pp. 58- 60, reachable at https://www.wto.org/english/res_e/booksp_e/world_trade_report14_e.pdf (last visited 28/06/2015).

[132] UNCTAD, *Trade and Development Report*, 2014, New York and Geneva, pp. 3- 4, reachable at http://unctad.org/en/PublicationsLibrary/tdr2014_en.pdf (last visited 28/06/2015).

[133] OECD*, "Transfer Pricing Comparability Data and Developing Countries"*, March 2014, Paris, p. 2, reachable at http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-comparability-data-developing-countries.pdf (last visited 28/06/2015).

with reduced reliance on direct comparables and to improve the APA and MAP proceedings[134].

Regarding the enlargement of the access to data sources for comparables in developing countries, the OECD proposes to improve developing countries coverage by commercial suppliers and to introduce for taxpayers the obligation to file statutory accounts and make them public. The BEPS Monitoring Group has considered this option of little use, as it would require many resources from tax administrations and the data that could be included will still be reduced, as the number of companies operating in a certain sector will still be low[135].

As for the possibility of statutory accounts being filed and published, the US Council for International Business considers it would be imprudent, as trade secrets or other confidential information would be publicly available for the company's competitors and could be used against it[136].

The proposal to reduce reliance on direct comparables has been surprisingly supported by the BEPS Monitoring Group, arguing that in developing countries resources should not be employed for applying ALP, as it is too complicated for them, but to find simpler ways to appropriately tax MNEs[137].

4.2 Action 13 of the BEPS Action Plan and developing countries

One of the topics approached through the BEPS Action Plan is the re-examination of transfer pricing documentation, in order to ensure that taxpayers give appropriate consideration to transfer pricing requirements and provide tax administrations with the information needed to conduct TP risk assessment and audit of the TP practices of entities subject to tax in their jurisdiction[138].

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[134] Ibidem, pp. 3-4.

[135] BEPS Monitoring Group comments on Supra note 129, pp. 4- 5, reachable at http://www.oecd.org/ctp/transfer-pricing/bmg-comparibility-data-and-developing-countries.pdf (last visited 28/06/2015).

[136] US Council for International Business comments on Supra note 129, p. 2, reachable at http://www.oecd.org/ctp/transfer-pricing/uscib-comparability-and-developing-countries.pdf (last visited 28/06/2015).

[137] Supra note 16, p. 7.

[138] Supra note 23, p. 14.

4.2.1 Documentation requirements

In order to provide administrations with all the useful information necessary, three different reports are required to be completed by entities operating in a country on an annual basis: a master file, a local file and a country by country report[139].

The master file is aimed to assist tax authorities when evaluating transfer pricing risk, so it will include information on the MNE group's organizational structure, a description of its business, its overall transfer pricing policies and its global allocation of income and economic activity. There is no need of detailed information, but all relevant information should be included, such as important agreements, intangibles and transactions[140].

As for the local file, the information it provides is much more precise, related to specific intercompany transactions ,as it is aimed to help tax administrations verify that the taxpayer has properly set its transfer prices in the country[141].

The most relevant document is the country by country report, presented in the country of the parent company and which provides information regarding allocation of income, taxes paid and location of economic activity from all the tax jurisdictions in which the MNE group operates, along with the listing of all the entities part of the group[142]. See Annex for a copy of the model template proposed for the report.

4.2.2 Implementation of the Country by Country Report

It is recommended that the first country by country reports be filed for the MNE's fiscal years beginning after 1 January 2016 and all taxpayers with a global revenue of at least €750 million in the immediately preceding fiscal year should be required to file it[143].

When obtaining and using the reports, tax administrations are subject to three conditions: confidentiality, consistency and appropriate use. Therefore, appropriate legal protection must be assured for the confidential information that might be included in the reports,

[139] Supra note 23, p. 17.

[140] Supra note 23, p. 18.

[141] Supra note 23, p. 19.

[142] Supra note 23, p. 19.

[143] OECD, *Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting*, OECD Publishing, 2015, p. 4, reachable at http://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf (last visited 28/06/2015).

internal tax law must be modified to include the report's requirements in the terms indicated (countries cannot modify the information required in the report by reference to the template presented) and the information will only be used for high-risk transfer pricing assessment[144].

Countries participating in the BEPS Project have agreed to implement a mechanism for automatic exchange of Country by Country Reports within the jurisdictions in which a MNE operates[145].

Recently, further guidance for implementation has been published, providing tax administrations with model legislation to include the Action 13 documentation requirements in national corporate tax law. Also, guidance has been provided for the implementation of automatic exchange of information through Multilateral Competent Authority Agreement, based on the Convention on Mutual Administrative Assistance in Tax Matters. Special concern has been shown for confidentiality and data safeguard when exchanging information within multiple countries[146].

The implementation of this reporting requirements are likely to assist tax administrations in TP risk assessment and audit controls, thereby reducing profit shifting through TP. But in the author's opinion, their use for taxpayers is reduced, as no additional information on comparables will be reachable for them when conducting TP.

4.2.3 Reference to Spanish tax law and Asia- Pacific developing countries

Following the work of the BEPS Project, some countries are already incorporating the provisions in Action 13 into national corporate tax law. This would be the case in Spain, where a draft on the modification of the Corporate Income Tax Regulations has been released for public comments. It is expected that the final version enters into force in

[144] Ibidem., p. 5.

[145] Ibidem., p. 6.

[146] OECD/ G-20 BEPS Project, *Action 13: Country-by-Country Reporting Implementation Package*, OECD Publishing, 2015, reachable at http://www.oecd.org/ctp/transfer-pricing/beps-action-13-country-by-country-reporting-implementation-package.pdf (last visited 28/06/2015).

January 2016 and so, the first reports would be filed 2017 by Spain based multinationals with a turnover of at least €750 million[147].

This new modification includes the regulation of both local and master files, apart from the country by country report. All three documentation requirements are configured following the Action 13 Deliverable terms[148].

Given the fact that the currently most important developing economies- Brazil, China and India- are not OECD members, the author considered important to find out their position towards the new documentation standards proposed. Indian and Chinese tax authorities have expressed their intentions of introducing the Action 13 proposals into their national tax laws in the timeline provided for OECD countries. In return, they both intend to require additional information and give it a use beyond risk assessment. Following the tax tendencies in both countries, it is expected that the information will be used for formulary reallocation of profits[149].

4.3 Deviation from arm's length principle: Brazil's case

Brazil has one of the most peculiar transfer pricing system worldwide. It does not follow the OECD Guidelines, but neither it opts for a specific alternative, like FA. It could be said that Brazil has developed a transfer pricing system adapted to its economic profile.

One of the most relevant differences with the OECD approach is that TP rules differ for imports and exports and are applicable, besides to transactions within associated

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[147]KPMG, *"Spain near to adopt BEPS Action 13 transfer pricing documentation standards",* 2015, reachable at https://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/tp-spain-march31-2015.pdf (last visited 28/06/2015).

[148] Ministry of Finance and Public Administration, Draft of the Royal Decree approving the new Corporate Tax Bylaw, see Chapter V, reachable in Spanish at http://www.minhap.gob.es/Documentacion/Publico/NormativaDoctrina/Proyectos/Tributarios/Proyecto_RD_Reglamento_Sociedades.PDF (last visited 28/06/2015).

[149] KPMG, ASPAC Survey, *Country Survey on Implementation of OECD'S BEPS Action Plan 13*, 2015, pp. 5- 9, reachable at https://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/Country-Survey-on-OECD-BEPS-Action-Plan-13-201501.pdf (last visited 28/06/2015).

enterprises, to operations with independent parties located in listed low-tax jurisdictions or tax havens[150].

The methods accepted by the Brazilian TP rules are the CUPM, the RPM and the CPM, having taxpayers the option of choosing which to apply. However, the CUPM, as comparables are difficult for taxpayers to find, remains a residual method[151].

Both RPM and CPM are applied in a different manner to the OECD Guidelines, as there is no reliance on comparable transactions, but fixed margins are used. In the case of RPM, when used for imports, a profit margin of 20% to 40% is applied, depending on the business sector of the MNE. Regarding exports, the margin in the foreign country will be 15% for wholesale and 30% for retail sales[152].As long as CPM's fixed margins concern, they will be 20% for imports and 15% for exports[153].

The main advantage of this TP system is that there is no dependence on uncontrolled comparable transactions. Also, it gives predictability on tax liability, it reduces costs for taxpayers and administrations and it is simple to apply by taxpayers[154].

However, the application of the Brazilian rules at international level would impose many difficulties, as not all countries have the same business profile and therefore, the margins applied in Brazil for each business sector might not make sense in other countries[155].

5. Arm's length: update or die?

One of the most frequent arguments within ALP defenders is the international acceptance it has gained and the efficiency it has proven in the majority of cases[156].

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[150] Baker & McKenzie, *Transfer Pricing in Brazil*, 2011, p. 3, reachable at http://www.bakermckenzie.com/files/Uploads/Documents/Locations/Dallas/4_dallasglobalseminar_transferpricingbrazil_mar11.pdf (last visited 23/06/2015).

[151] MEGADLIA, T., "Brazilian transfer pricing rules", International Tax Review, June 2014, pp. 3-4, reachable at http://www.internationaltaxreview.com/Article/3354483/Brazilian-transfer-pricing-rules.html (last visited 23/06/2015).

[152] Supra note 13, at Chapter X, para. 10.2.2.11- 10.2.2.13.

[153] Supra note 13, at Chapter X, para. 10.2.3.3.

[154] Supra note 13, at Chapter X, para. 10.2.7.1.

[155] Supra note 13, at Chapter X, para. 10.2.9.2.

[156] SADIQ, K., "The traditional rationale of the arm's length approach to transfer pricing – should the separate accounting model be maintained for modern multinational entities", *Journal of Australian*

Another advantage sustained is that it eliminates tax incentives for entering a foreign market through direct investment, in comparison with transacting with unrelated foreign based entities. By giving equal tax treatment to MNEs and independent parties, a company's decision of operating abroad will not be affected by tax consequences, but merely based on commercial reasoning[157].

Also, the ALP is said to accurately allocate income among the entities of a MNE, in proportion to each affiliate's economic activity[158]. Nonetheless, we have seen through many examples that this is no longer true, as TP under the ALP is currently being used as a mechanism of tax avoidance, which distorts the tax burden in the jurisdictions in which the MNE operates.

In this situation, and taking into account the increasing importance that intangibles are acquiring in the globalized economy, it seems clear to the author that the ALP needs an update taking into account these challenges. Otherwise, it is likely to be gradually replaced by other approaches.

Currently, the most important initiative aiming the revision of TP rules is the OECD/G-20 BEPS Project, which focuses on the pressure areas of BEPS and proposes solutions in order to align TP outcomes with value creation[159]. Even though OECD strongly defends the improvement of the ALP instead of its substitution, it states that "special measures, either within or beyond the arm's length principle, may be required with respect to intangible assets, risk and over-capitalisation to address these flaws"[160].

Taxation, 2004, pp. 225- 226, reachable at http://www.buseco.monash.edu.au/blt/jat/2004-issue2-sadiq.pdf (last visited 25/06/2015).

[157] Ibidem, pp.253- 236.

[158] Ibidem, p. 245.

[159] KOFLER, G., "The BEPS Action Plan and Transfer Pricing: The Arm's Length Standard Under Pressure?", *British Tax Review*, 2013 (5), p. 664, reachable at https://www.jku.at/steuerrecht/content/e186180/e186181/e187213/e228655/BEPSandTransferPricing_153_ger.pdf (last visited 25/06/2015).

[160] Supra note 22, p. 20.

A similar proposal is the one that brings forward the possibility of using a formula based on payroll, tangible assets and sales to distribute the residual profit when using the Profit Split Method[161].

However, some authors think that a mixed approach- using ALP for most transactions, but applying alternative methods for transactions involving certain assets, like intangibles- along with differential rates and tax bases within countries, will affect MEN's location decisions and would not be efficient tackling the current problems of tax avoidance[162].

For the moment, both OECD member countries and other important not member, but collaborators, like India and China, are expecting to see the outcome of the BEPS Project and its effectiveness avoiding profit shifting.

But still there are some defenders of a radical change in international taxation towards a formulaic approach. To them, it seems much more realistic from an economic point of view to treat MNEs as a whole and tax them according to the sales, employees and capital they have in each jurisdiction where they operate[163].

III. ALTERNATIVE TO THE ARM'S LENGTH PRINCIPLE: FORMULARY APPORTIONMENT

There is a debate in the TP world surrounding the current rules and their ability to prevent tax avoidance, nowadays a major problem for international tax. When discussions take the path towards the substitution of the current approach -ALP- by unitary taxation -FA- the reactions tend to be critical. The major arguments are, firstly that the implementation of the FA would require wide international consensus and coordination; secondly that it

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[161] AVI-YONAH, R. S., "Between Formulary Apportionment and the OECD Guidelines: a proposal for reconciliation", *World Tax Journal*, February 2010, pp. 16- 17.

[162] UK Committee of Economic Affairs, *"Tackling corporate tax avoidance in a global economy: is a new approach needed?"*, Published by the Authority of the House of Lords, 2013, London, p.31, reachable at http://www.publications.parliament.uk/pa/ld201314/ldselect/ldeconaf/48/48.pdf (last visited 25/06/2015).

[163] STIGLITZ, J. E., "Reforming Taxation to Promote Growth and Equity", *Roosevelt Institute*, May 2014, p. 16, reachable at http://rooseveltinstitute.org/sites/all/files/Stiglitz_Reforming_Taxation_White_Paper_Roosevelt_Institute.pdf (last visited 26/06/2015).

is an inflexible approach because it calculates taxes following a predetermined formula and with no regards to individual facts and circumstances and third that agreement upon the concepts included in the taxable base would be needed, along with tax and accounting international standards[164].

Nevertheless, there are not only disadvantages about the FA approach. Some authors consider that a formulaic approach would significantly reduce the incentive to shift profits towards low tax jurisdictions and particularly in developing countries it would strengthen the fiscal position of the State. As for taxpayers, the adoption of FA would reduce accountancy costs and would put enterprises on an equal foot for tax treatment: tax liabilities would not depend on the company's ability to carry on an aggressive tax planning[165].

However, a deeper insight at the approach is needed in order to consider the possibility of its international adoption.

1. Definition of Formulary Apportionment

Formulary apportionment is one of the approaches that can be used to determine the tax burden of a MNE. Under this method, the profits of all the entities being part of the MNE are consolidated in a first step. In a second phase, those profits are apportioned between the subsidiaries, depending on the activity each subsidiary has in the distinct jurisdictions in which the MNE does business[166].

When the Fiscal Committee of the League of Nations, along with the International Chamber of Commerce, started to work on the taxation of multinational companies in the

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[164] GHARKY, D., *"Arms Length Method vs. Formulary Apportionment: Is there a best method?",* Thomas Jefferson School of Law, 2012, p. 10, reachable at https://www.academia.edu/3863027/Arms_Length_Vs._Formulary_Apportionment_Is_there_a_best_method (last visited 24/06/2015).

[165] MOLD, A., "A proposal for unitary taxes on the profits of transnational corporations", *CEPAL Review*, April 2004, p. 45, reachable at http://www.cepal.org/en/publications/11008-proposal-unitary-taxes-profits-transnational-corporations (last visited 24/06/2015).

[166] BUTT, A., *"Formulary Apportionment in the European Union",* Master's Thesis, University of Lund, Faculty of Law, 2004, p. 11, reachable at http://lup.lub.lu.se/luur/download?func=downloadFile&recordOId=1556580&fileOId=1564036 (last visited 16/06/2015).

1930s, before ALP was adopted, there was also a proposal to adopt FA as an international approach, as it was already being used in some countries, like Spain[167].
However, the formula was rejected by the Committee, as it was considered that tariff barriers along with differences in language, currency and accounting systems would result in "insurmountable" difficulties for tax administrations in its application[168].
Anyway, some federal countries have adopted the FA in their national tax systems, like the United States and Canada.
The United States started using the FA at the end of the 19th Century, in the context of railway lines' development. Formally, the first state to adopt corporate income tax was Wisconsin, in 1911, using a formula based on property, cost of manufacture and sales. After a decision of the Supreme Court in 1920, stating that the apportionment method for distributing the net income of a manufacturing corporation across the states for income tax purposes was constitutional, most states started adopting the formulary method. The National Tax Association declared in 1933 that the best way of calculating the weight of the factors in the formula was the "Massachusetts formula": equally-weighted property, payroll and gross receipts factors. However, since the early 1980s, the general trend is moving towards a formula that increases the weight on the gross receipts factor and decreases the weight on property and payroll[169].
As for Canada, some provinces adopted the corporate income tax well before the federal government. Coordination between the provinces and the federal government was only established after World War II, when a model provincial Corporate Income Tax Act was developed and the Tax Rental Agreements created. The first application of the FA was subordinated to the lack of separate accounts of the PE that corporations had in many

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167 WEINER, J. M., " Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level", *US Department of the Treasury*, April 1999, pp. 3-4, reachable at http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota83.pdf (last visited 16/06/2015).

168 Ibidem, pp. 4- 5.

169 European Commission, Directorate-General Taxation & Customs Union, *"Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada",* Working paper nº 8/2005, 2005, pp. 10- 12, reachable at http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/2004_2073_en_web_final_version.pdf (last visited 25/06/2015).

provinces. After multiple changes, the Canadian provinces have generally used an equally weighted payroll and gross revenue formula and still they retain significant autonomy, as they may apply their own local tax rates and tax credits to the post-allocation tax base[170].

2. Is it time to adopt Formulary Apportionment at the international level?

The ALP proved to be efficient in MNE's taxation in the 20th Century, but it has not updated at the rhythm of business' development. Therefore, a change in international taxation seems to be urgently needed for many authors, in order to adjust taxation to the current MNE model: cross- border transactions involving intangibles, complex corporate structure and global business[171].

Currently, one of the main TP problems is profit shifting by MNEs, which is why FA's advocates consider it the appropriate alternative to adopt: it links tax liabilities with the jurisdictions of the real economic activity of the group[172].

Once FA would be implemented, international taxations is likely to be more efficient than it is nowadays. However, some efforts would be needed to make possible its implementation, mainly of economic and political nature. In the author's opinion, an analysis of the benefits and downsides of the approach is needed as to be able to assess the worthiness of the efforts needed for FA adoption.

2.1 The advantages of Formulary Apportionment

The shift from the current TP rules to a FA system would bring many advantages, for both taxpayers and tax administrations.

In the first place, the most significant advantage is that FA would eliminate the illusive search for uncontrolled comparables prices currently needed under the ALP. That way,

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[170] Ibidem, pp. 14- 15.

[171] WEINER, J. M., "It's time to adopt Formulary Apportionment", *Tax Analysts*, 2009, p. 103, reachable at http://www.taxanalysts.com/www/freefiles.nsf/Files/WEINER-30.pdf/$file/WEINER-30.pdf (last visited 25/06/2015).

[172] Ibidem., p. 104.

the taxes due by MNEs would be more closely related to the real economic activity they develop in each country[173].

A second advantage of FA is the elimination of tax incentives to shift income to low or no tax jurisdictions through the mispricing of intangibles or other legal and accounting mechanisms. Under the current system, profit shifting is a major issue. An illustrative example could be seen in the operations of US multinationals: while over 40% of their employees outside the US are located in the UK, Canada, Mexico and Germany, the profits arising in those countries are slightly over 20% of the worldwide total. Another contrasting and shocking fact is that the profits arising from the Netherlands, Ireland and Bermudas (low or no tax jurisdictions) amount to over 30% of the total, while the employment in those countries is under 6% of the total[174].

With the adoption of the FA proposal, profit shifting towards tax havens and low tax jurisdictions would be strongly reduced and, therefore, the benefits of the approach would not only be perceived in the MNEs' tax burden, but also in the general tax policy of each State: pressures of tax competition would be drastically reduced[175].

Another advantage that the adoption of a formulary system would bring is simplicity. The current documentations requirements and search for comparables would be substituted by far lighter compliance burden for taxpayers. On the side of the tax authorities, administrative savings are likely to be considerable (audit and litigation would be reduced)[176].

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[173] TAN, J. H. D., *"Unitary Formulary Apportionment as a Solution to the Conundrum of Source",* Master's Thesis, New York University School of Law, 2010, p. 6, reachable at http://www.jmls.edu/academics/taxeb/pdf/Faherty_1.pdf (last visited 25/06/2015).

[174] Tax Policy Center, *"A Citizen's Guide for the 2008 Election and Beyond- International Taxation",* 2008, Figures 1 and 2, reachable at http://datatools.taxpolicycenter.org/briefing-book/ii-key-elements/ii-15international.pdf (last visited 25/06/2015).

[175] AVI- YONAH, R. S., CLAUSING, K. A. and DURST, M.C., "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split", *Florida Tax Review*, 2009, p. 511- 512, reachable at http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1773&context=articles (last visited 25/06/2015).

[176] Ibidem., pp. 512- 513.

2.2 The disadvantages of Formulary Apportionment

In case the international community agrees to shift to a FA system, there will also be some difficulties, mainly related to its implementation. However, ALP advocates insist on highlighting that FA would be more unstable than ALP. A view over the main problems of FA can be clarifying.

The main concern about FA is arbitration: would the proposed system be arbitrary? For some experts, the answer must be positive, as the tax liabilities would depend on a pre-established apportionment formula. It needs to be admitted that for some industries, the new approach might be arbitrary (oil industry, for example). But overall, it would not be more arbitrary than the current system, which faces a huge problem of profit shifting, previously mentioned[177].

A further issue would be the geographic distribution of sales revenue, as there will be some difficulties to differentiate sales for final use as opposed to storage, for example. Probably, this type of concerns will need a detailed regulation in order to avoid mismatches, being aware of the fact that a change towards FA would not be perfect, but just more reasonable and effective than the currently applicable[178].

Some others have raised the question about the effect that a FA system would have on the current tax treaty system, as most tax treaties are based on the ALP[179]. It must be kept in mind the fact that FA could only be introduced in international tax rules if countries agree to it, probably through an international forum or organization, like the OECD. Therefore, when debating the possibility, countries may agree on a transition mechanism, so that tax treaties can be adapted following a standard procedure.

Also, the coordination between countries with different tax systems raises serious concern, as consensus seems difficult to reach[180]. Many authors sustain that the EU might serve as a guide for this topic. Even if the situation of the EU cannot be compared with the worldwide problematic, the approach used for tax systems’ coordination within the

[177] Ibidem., p. 516.

[178] Ibidem., p. 517- 518.

[179] Ibidem., pp. 523- 524.

[180] Ibidem., p. 519.

CCCTB context might by inspiring in case the FA is eventually internationally approached.

3. The European Union Approach: CCCTB

The EU has discussed the possibility of shifting from the ALP approach towards another system based on formulaic apportionment during several years. The Ruding Report in 1992 pointed out many of the problems that such a change would suppose for the EU and insisted on the fact that much more integration is needed within the MS in order for such a system to be favorable[181].

In 2001, in view of the developments experienced in economic integration, along with the technological advances, the EC decided it was time to rethink its corporate tax policy in order to remove tax obstacles to cross- border economic activities in the internal market. It was considered that the only manner to do so would be through a consolidated corporate tax rate, provided for MNEs for their EU- wide activities. It was affirmed that such a new system would "contribute to greater efficiency, effectiveness, simplicity and transparency"[182].

The EC highlighted in 2003 that the development and implementation of the common consolidated tax base would have to take into account the International Financial Reporting Standards[183].

[181] FJORDEVIK, T., *"Formulary Apportionment- a realistic alternative to the arm's length principle within the EU?",* Master's Thesis, University of Lund Faculty of Law, 2001, pp. 48- 49, reachable at http://lup.lub.lu.se/luur/download?func=downloadFile&recordOId=1557476&fileOId=1564334 (last visited 29/06/2015).

[182] European Union, COM(2001) 582, *Towards an Internal Market without tax obstacles- A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities,* October 2001, Brussels, p. 15, reachable at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001DC0582&from=EN (last visited 29/06/2015).

[183] European Union, COM(2003)726*, An Internal Market without company tax obstacles: achievements, ongoing initiatives and remaining challenges,* November 2003, Brussels, p. 17, reachable at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52003DC0726&from=EN (last visited 29/06/2015).

The EC was very active on this topic during the 2000 and in 2011 a proposal for a directive on CCCTB was released. It is now worth to analyze that proposal and its implications, along with the brand new Action Plan launched by the EU.

3.1 Initial proposal and development

The 2011 proposal was launched with the main objective of tackling fiscal issues that suppose an impediment for the growth of the Internal Market. The EC aimed to assure tax consistency, but without attacking the MS' tax sovereignty: tax rates would remain up to the MS to decide, allowing fair tax competition[184].

In the author's opinion, the main topics of interest to mention here are the rules for determining the tax base, the consolidation rules and the apportionment process, as they are identified with the steps of the whole process: calculation of each enterprise's tax base, consolidation of the entire group's tax bases and finally, division or apportionment between the MS.

The tax base is defined as "revenues less exempt revenues, deductible expenses and other deductible items"[185]. Therefore, we can say that the Directive Proposal adopts a "profit and loss" approach to calculate the tax base of each entity of the group[186].

When consolidating the tax bases of the members of the group, profit and losses arising from transactions within related parties shall be ignored[187]. However, this statement is confusing, as there is no further guidance about what should be done with those profits or losses: ignore them, record them as a cost or include the net profits or losses on the consolidation[188].

Given the example of an MNE operating in France, Germany, Italy and Portugal, the following table shows the revenues in each countries and the consolidated tax base under the CCCTB:

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[184] Supra note 51, Explanatory Memorandum.

[185] Supra note 51, Article 10.

[186] KPMG, *"The KPMG Guide to CCCTB"*, 2011, p. 32, reachable at https://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/ccctb-part2.pdf (last visited 01/07/2015).

[187] Supra note 51, Article 59.

[188] Supra note 186, p. 44.

	France	Germany	Italy	Portugal	TOTAL
Revenues	1.500.000,00 €	2.000.000,00 €	800.000,00 €	950.000,00 €	5.250.000,00 €
(Exemp. Rev.)	300.000,00 €	500.000,00 €	320.000,00 €	410.000,00 €	1.530.000,00 €
(Deduct. Exp.)	240.000,00 €	360.000,00 €	120.000,00 €	170.000,00 €	890.000,00 €
(Other Ex. Items)	125.000,00 €	200.000,00 €	80.000,00 €	98.000,00 €	503.000,00 €
TAX BASE	835.000,00 €	940.000,00 €	280.000,00 €	272.000,00 €	**2.327.000,00 €**

Under this approach, the consolidated profits are shared between the group members following an apportionment formula based on three equally weighted factors: sales, labour and assets[189]:

$$\text{Share A} = \left(\frac{1}{3}\frac{\text{Sales}^{A}}{\text{Sales}^{Group}} + \frac{1}{3}\left(\frac{1}{2}\frac{\text{Payroll}^{A}}{\text{Payroll}^{Group}} + \frac{1}{2}\frac{\text{No of employees}^{A}}{\text{No of employees}^{Group}} \right) + \frac{1}{3}\frac{\text{Assets}^{A}}{\text{Assets}^{Group}} \right) * \text{Con'd Tax Base}$$

Following the previous example, the share of each country in the consolidated tax base would be as indicated below:

	France	Germany	Italy	Portugal	TOTAL
Sales	1.500.000,00 €	2.000.000,00 €	800.000,00 €	950.000,00 €	5.250.000,00 €
Payroll	200.000,00 €	260.000,00 €	120.000,00 €	155.000,00 €	735.000,00 €
Nº of Employees	100	120	80	105	405
Assets	2.000.000,00 €	3.500.000,00 €	1.950.000,00 €	1.700.000,00 €	9.150.000,00 €
Share	**592.457,87 €**	**844.301,48 €**	**423.431,62 €**	**466.809,03 €**	**2.327.000,00 €**

It is worth commenting the labour factor, as it has two elements: payroll of the work force (all employee compensation) and number of employees[190].

The main reasons that have led the EC to adopt a FA are its simplicity for both taxpayers and tax authorities, its ease to be audited by tax administrations, its difficult manipulation by taxpayers, the fair and equitable distribution of the tax base that it assures and the avoidance of abusive tax competition[191].

One may think that following the adoption of the CCCTB in the EU internal market, transfer pricing are not applicable anymore in the EU. However, that is not

[189] Supra note 51, Article 86.

[190] Supra note 186, p. 61.

[191] Supra note 186, p. 59.

completely accurate: it is only true for the entities that are member of a CCCTB group and have opted to apply the system[192].

3.2 Action Plan for Fair and Efficient Corporate Taxation in the EU

The EU has recently launched an Action Plan for Fair and Efficient Corporate Taxation in the EU, focused on five key actions that are considered to be needed for a more coordinated corporate tax environment within the EU[193]. Also, another reason to develop this project is the need to adapt the OECD initiatives within BEPS to the singularities of the EU, such as the single market, the single currency area and the fundamental freedoms enshrined in the Treaties[194].

The first action addressed would be the re- launch of the CCCTB, with mainly two important changes: it would become mandatory and it would be implemented through a step-by-step methodology.

Following the timeline set for the Action Plan, it seems to be a step forward from BEPS, within the EU: the first step in the edit of the current CCCTB is the agreement upon anti-avoidance measures proposed by BEPS. Only when those measures will be agreed, the new CCCTB proposal is going to be forwarded at some stage during 2016, assuring that way that there will be no contradictory outcome within the OECD and the EU as for tax avoidance[195].

The choice for a mandatory CCCTB is motivated by its higher efficiency in preventing profit shifting: the EC arguments that if the proposal remains optional, MNEs that are currently using aggressive tax planning to minimize their profits, will hardly opt for CCCTB[196].

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[192] Supra note 186, p. 55.

[193] European Union, COM(2015) 302, *"A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action"*, June 2015, Brussels, pp. 7- 8, reachable at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/fairer_corporate_taxation/com_2015_302_en.pdf (last visited 01/07/2015).

[194] Ibidem., p. 6.

[195] Timeline for Action Plan for Fair and Efficient Corporate Taxation, reachable at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/fairer_corporate_taxation/tax_timeline_new.pdf (last visited 02/07/2015) .

[196] Supra note 193, p. 8.

The most difficult aspect of the 2011 proposal has been the agreement upon consolidation between MSs, so the EC proposes to work on the settling of the common tax base initially, during 2017. That way, the MSs' positions towards the initiative will probably be closer when the consolidation process will be discussed[197].

The other four actions are of high importance for the success of the CCCTB re-launch, as they provide the proper conditions for a formulaic approach to succeed. One of the other actions aims to ensure that profits are taxed where they are generated and in order to do so, the EU intends to work on the guidelines provided by the BEPS Project[198].

Further on, a better tax environment is proposed to be created within the EU, mainly through the improvement of the double taxation dispute resolution mechanisms (currently, the AC provides some relief, but it is still limited to transfer pricing) and the possibility for taxpayers to offset profit and losses they make in different MS (further guidance and limitations need to be published on this topic)[199].

Another crucial initiative is the enhancement of tax transparency. They key points would be the provision of a common approach to identify and deal with non-cooperative tax jurisdictions in preventing aggressive tax planning on one hand and the agreement upon the additional information requirements in the Country-by-Country Report that could be implemented within the EU[200].

As a last area of work, the EC strongly recommends a reinforcement of the current coordination mechanisms available within the EU for the MS. The most relevant actions would be the improvement of the coordination on tax audits and the reform of the Code of Conduct for Business Taxations and the Platform on Tax Good Governance[201].

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[197] Supra note 193, p. 8.

[198] Supra note 193, p. 10.

[199] Supra note 193, pp. 10- 11.

[200] Supra note 193, p. 13.

[201] Supra note 193, p. 14.

4. The design of an international tax system based on Formulary Apportionment

Under FA, MNE are not taxed on the income declared in each jurisdiction where it does business. Instead, it is considered that some factors, namely sales, labour and assets, fairly indicate the portion of tax attributable to each jurisdiction[202].

When designing an international system based on FA, there are many concerns that arise, as any loophole would be fatal to the aim of the proposal, which is preventing tax avoidance. In the author's opinion, there are three vital elements that must be defined in detail, in order to assure international coherence: the tax base and the apportionment factors and formula.

Also, it must be kept in mind that all the considerations under this paragraph are based on the FA systems currently applied at national levels. If FA was adopted internationally, some specific rules would be needed, in order to make the approach more efficient.

4.1 Tax base

One might consider that under the FA, the consolidated accounts of a MNE provide all the information needed to apply the method, considering the consolidated profit as the tax base. However, accounting and tax convergence is far from making possible such an option, even thou efforts have been made in the recent years towards defining financial accounting standards[203]. Some of the most relevant initiatives towards accounting standardization are being carried by the IFRS Foundation and the IABS[204].

When calculating the taxable income under the FA, there must be considered which parts of the taxpayers' income are ought to be allocable and the rules defining the tax base itself.

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[202] CRUZ, M. J. M., *"Transfer pricing and the arm's length principle in the European Union law and domestic law"*, Master's Thesis, Universidade do Minho- Escola de Direito, 2013, p. 46, reachable at http://repositorium.sdum.uminho.pt/bitstream/1822/28395/1/Transfer%20pricing%20and%20the%20arms%20length%20principle%20in%20the%20European%20Union%20law%20and%20domestic%20law-3.pdf (last visited 25/06/2015).

[203] SIKKA, P. and MURPHY, R., "Unitary taxation: tax base and the role of accounting", ICTD Working Paper 34, 2015, p. 12, reachable at http://www.ictd.ac/sites/default/files/ICTD%20WP34.pdf (last visited 02/07/2015).

[204] For more details, visit http://www.ifrs.org/Pages/default.aspx (last visited 06/07/2015).

On a general basis, only business income is going to be taxable, excluding non- business income. Therefore, it is important to distinguish these two concepts. Business income refers to the one that arises from transactions and activity in the regular course of the taxpayer's trade or business. Income from intangible property is only considered business income if it serves an operational function rather than solely an investment function[205]. Usually, all income is presumed to be business income, unless it is clearly classified as non- business, which usually refers to rents and royalties from personal property, capital gains and losses, interest, dividends and patent or copyright royalties[206].
In order to obtain the tax base, specific rules need to be indicated, as the starting point are the accounts of the enterprise. This is one of the most sensitive issues of FA, as there are probably no two countries which calculate the tax base in an identical way. Therefore, specific measures would be needed on this topic is FA was adopted. In the author's opinion, the best option would be to provide an international definition of tax base and the proper indications for calculations. Currently, a similar work in being done in the accounting field, trying to bring all countries to use the same standards, so it would not be impossible to coordinate both systems- tax and accounting- to achieve a global definition of tax base[207].

4.2 Apportionment factors and formula

Once the tax base is calculated, it has to be divided among all the jurisdictions where the MNE operates. In order to do so, there are multiple approaches. The most known methodologies are the *Massachusetts formula*, used in the US and the two- factors formula from Canada. Here it is going to be proposed a third option: a single factor formula, based on sales.
Regarding the first option, three factors are considered for the apportionment: sales, payroll and assets, all of them equally weighted. It is worth mentioning here that the

[205] Supra note 169, p. 34.

[206] Supra note 169, p. 34.

[207] Supra note 173, p. 13.

payroll factor differs from the labour factor in the CCCTB formula. The US approach only considers payroll, with no reference to the number of employees[208].

As for the Canadian formula, it eliminates assets from the formula and it weights equally sales and payroll. A separate entity approach is used, which is supposed to increase profit shifting. However, this is not the case in Canada, as the FA is highly administered by the federal tax authorities[209].

The third option would be a formula based on sales. Reuven Avi- Yonah and Kimberly Clausing have proposed this formula for two main reasons. On one hand, they consider that FA system creates an implicit tax on the factors included in the formula, therefore discouraging the location of employment and assets in high- tax jurisdictions. On the other hand, it is relevant to note that under the other alternatives, intangibles are left out of the formula. Even if their value might be considered to be included in the overall of the MNE (and by extent, in the tax base), they still consider that they cannot be ignored when establishing a FA[210].

The main advantage of this formula is that sales are far less responsive to tax differences between markets, as costumers do not have the power to move as MNE do. Also, it is well- known that firms have an incentive to sell everywhere, no matter how high taxes are. Therefore, profit shifting would be quite fairly prevented[211].

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[208] PETUTSCHNIG, M., *"Common Consolidated Corporate Tax Base: Effects of Formulary Apportionment on Corporate Group Entities",* Wirtschafts Universitat Wien, 2012, pp. 10-11, reachable at http://ssrn.com/abstract=2178004 (last visited 01/07/2015).

[209] DURST, M. C., "Analysis of a Formulary System for Dividing Income, Part II: Examining Current Formulary and Arm's-Length Approaches", *Tax Management Transfer Pricing Report*, Vol. 22 No. 5, 2013, p. 5, reachable at http://www.ictd.ac/sites/default/files/Files/Durst-Formulary-System-Part-II.pdf (last visited 01/07/2015).

[210] AVI- YONAH, R. S. and CLAUSING, K., "A proposal to adopt Formulary Apportionment for Corporate Income Taxation: the Project Hamilton", *Public Law and Legal Theory Working Paper Series Working Paper No. 85 June 2007 and John M. Olin Center For Law & Economics Working Paper No. 07-009,* University of Michigan Law School, 2007, pp. 9-11, reachable at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=995202 (last visited 01/07/2015).

[211] Ibidem, p. 12.

IV. CONCLUSIONS

The current standard for transfer pricing rules has proved to be efficient since its adoption, but in the recent decades tax avoidance has enormously increased in the context of transfer pricing, which has raised the question of whether this standard should be replaced. This is mainly due to the globalization process and the rise of intangibles as an important tool to communicate and do business.

International organizations like the OECD or the EU are working on the reconsideration of the method, analyzing the areas where it can be improved and the possible updates that can be undertaken.

In the author's opinion, the BEPS Project might have a huge global impact if non-OECD countries commit to it and follow the guidelines provided, mainly the Country-by-Country Report. The expectations created by BEPS are high and the international community would not appreciate a failure, given the time and capital costs it has caused. It could be the arm's length last chance of remaining the international standard.

Also, besides the OECD, the EU initiatives are relevant, given the fact that the MS of both organizations tend to follow similar tax policies. Therefore, if the CCCTB eventually succeeds within the EU, it is possible that a FA would be proposed internationally.

If no improvement of the current corporate tax system is reached in the coming years, regarding tax avoidance, the author considers the shift towards formulary apportionment would be advisable.

The simplicity of the FA system would suppose, along with the elimination of tax incentives to shift income to low or no tax jurisdictions and the elimination of the illusive search for comparables are enough reasons to approach the system.

Nevertheless, international coordination will be essential for the success of FA, as there are some sensitive areas that cannot be ignored, like the interaction of different tax systems and the loopholes that might appear.

V. ANNEX

A model template for the Country by Country Report[212]

Table 1. Overview of allocation of income, taxes and business activities by tax jurisdiction

Name of the MNE group: Fiscal year concerned:											
Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on cash basis)	Income Tax Accrued – Current Year	Stated capital	Accumulated earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

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Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

Name of the MNE group: Fiscal year concerned:															
Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of Residence	Main business activity(ies)												
			Research and Development	Holding or Managing intellectual property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision of Services to unrelated parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares or other equity instruments	Dormant	Other[2]
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

[2] Please specify the nature of the activity of the Constituent Entity in the "Additional Information" section.

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[212] Obtained from Supra note 23, Annex III to Chapter V.

Table 3. Additional Information

Name of the MNE group: Fiscal year concerned:
Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the country-by-country report.

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