

## The Arm's Length Standard

### Making It Work in a 21st-Century World of Multinationals and Nation States

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#### 6.1 INTRODUCTION

The twenty-first-century world is dominated by multinational enterprises (MNEs) and nation states, and the role of MNEs in this world is growing ever more important. According to UNCTAD (2011), there are now more than 100,000 multinational enterprises (MNEs) and about 900,000 foreign affiliates, that is, an average of nine foreign affiliates per MNE. Of the world's 100 largest economies, forty-two are MNEs not nation states, if one compares the dollar values of MNE revenues with the gross domestic products of nation states (Eden, 2012). Moreover, UNCTAD (2010) estimates that cross-border transactions that take place within MNEs are now one-third of world exports. Given the dominance of MNEs—and of trade within MNEs—in the twenty-first century's global economy, I see the workability of the arm's length standard as a critically important issue for global tax justice.<sup>1</sup>

The arm's length standard (ALS) is the core norm that underlies the pricing of transactions within multinational enterprises (MNEs) for purposes of determining corporate income tax payments in the home and host countries where the MNE operates.<sup>2</sup> The ALS requires that transfer pricing be based on

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<sup>2</sup> The ALS also applies to other government regulations such as customs duties and rules of origin. See, for example, Eden and Rodriguez (2004) and Eden (2012).

the prices that unrelated parties would negotiate if they were engaged in the same or similar transactions under the same or similar circumstances as the related party transactions (Eden, 1998, 2009; OECD, 2010). The pricing of intra-firm transactions is called *transfer pricing* and the price of an intra-firm transaction is called a *transfer price*.

The arm's length standard is almost eighty years old. It dates back to 1935 when Section 45-1(b) of the US Treasury Corporate Income Tax Regulations was published, defining the standard to be used by the IRS Commissioner in allocating corporate income tax among related parties as:

The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer.

The ALS spread rapidly and now more than seventy countries have some form of transfer pricing rules (Ernst & Young, 2013).

However, the criticisms against the arm's length standard have been mounting (see for example, Avi-Yonah, Clausing, and Durst, 2008; Picciotto, 2012, 2015; Sheppard, 2012, 2015). In reading through the enormous literature on the arm's length standard (ALS), the criticisms of the system as an approach to taxing MNEs, appear to fall into two categories: abusive transfer pricing and the lack of comparables.

The first set of criticisms revolves around what I call *abusive transfer pricing*. MNEs use transfer pricing as a method for avoiding paying corporate income taxes (CITs) and mispricing international trade flows. As a result, much of MNE profits escape paying any taxation, lowering the overall CIT rate on MNE profits, especially on large MNEs with sophisticated tax consultants, to close to zero. These activities can drain income out of developing countries and slow their economic development (Reuter, 2012; Christian Aid, 2009; Sheppard, 2012, 2015). Since developing countries now represent more than 50 percent of global inward foreign direct investment (FDI) flows and almost one-third of global outward FDI flows, the impacts of abusive transfer pricing can be of great consequence for developing countries (UNCTAD, 2013: ix). Moreover, certain types of intra-firm transactions, such as business services and intangibles, are critically important for economic development in the twenty-first century, and are especially difficult to price according to the arm's length standard in developing countries (Eden, 2005, 2012).

The economics literature on the problem of *abusive transfer pricing* or *transfer pricing manipulation* (TPM) has been studied by multiple scholars, as far back as Horst (1971) and Rugman and Eden (1985), as a response to differentials in government policies, especially corporate income tax (CIT) policies, across countries. I argue the incentives for TPM have grown much stronger as traditional home country governments over the past ten years have

moved from worldwide to territorial CIT systems, encouraging MNEs to use TPM to shift their profits into tax havens. Abusive transfer pricing is one of the key foci of the OECD's current recent BEPS (base erosion and profit shifting) initiative (OECD, 2013a, 2013b; Picciotto, 2013).

The second set of criticisms of the arm's length standard revolves around the *lack of comparables*. The ALS is based on a hypothetical goal—determining the price that would have been set between two unrelated parties engaged in the same or similar transaction under the same or similar facts and circumstances. I refer to the search for comparables as the “What would independent enterprises do (WWIED)?” question. The WWIED question is problematic from both theoretical and practical perspectives. From a theoretical perspective, the ALS compares transactions between related parties to those between unrelated parties. Many authors have argued this comparison makes no sense in theory given the integrated nature of the MNE because the comparison ignores the *raison d'être* for the MNE: the synergy benefits created by internalizing transactions (Picciotto, 2012, this volume; McIntyre, 2012; Langbein, 1991).

The WWIED question is also problematic in terms of putting the ALS into practice. The question requires that MNEs and governments search for evidence of the same or similar transactions conducted by unrelated firms under the same or similar facts and circumstances as the related party transaction. These can be either *external comparables* (open market transactions between unrelated firms) or, more likely in practice, *internal comparables* (MNE purchases from or sales to an unrelated party that are similar to the related party transaction). The transfer pricing rules require that MNEs prepare extensive contemporaneous documentation of their search for comparable transactions and provide arguments as to why one transfer pricing method should be used in preference to another method. As a result, MNEs have turned to searching databases such as Compustat, Orbis, and ktMINE to find comparable transactions. Finding comparables is difficult, even with these databases, and especially so for transactions involving high-value intangibles (which are not normally traded between unrelated parties) and developing countries (where markets are thinner and there typically are no databases). The search for “WWIED?” has therefore been criticized by many writers as expensive and ultimately impossible (see, for example, Avi-Yonah, 1995; Avi-Yonah, Clausing, and Durst, 2008).<sup>3</sup>

I assume that the ALS will be the predominant method used by national governments for taxing the profits of MNEs for at least the foreseeable future.

<sup>3</sup> Elsewhere, I have referred to this search for comparables, especially for high-value non-routine intangibles, as an example of the 1876 Lewis Carroll poem, “Hunting the Snark (An Agony in 8 Fits)” come to life.



I therefore focus my recommendations for change in terms of possible improvements to the existing system rather than for moving to a formula apportionment (FA) system.

## 6.2 REFORM PROPOSAL

### 6.2.1 The International Tax Regime

I have argued elsewhere (Eden, 1998, ch. 2) that MNE–state relations in the tax area are inherently conflictual simply because MNEs are integrated businesses; that is, they are groups of firms under common control that share common goals and resources.

For income tax purposes, MNEs almost always set up their foreign affiliates as legally independent subsidiaries. Profits earned within a host country by a foreign subsidiary are taxable by the host government under the so-called “source and water’s edge” rules. Because both home and host country governments claim the right to tax MNE profits, there can be double taxation or under taxation of MNE profits. Transfer pricing comes into play because the pricing of cross-border transactions within the MNE group of affiliated companies affects where the group’s profits are allocated for income tax purposes and therefore which government has the right to tax that income.

Because their transactions, income, and assets span many countries, the cross-border activities of MNEs bring them under the jurisdiction of multiple tax authorities. The integrated nature of MNEs makes it difficult for nation states to regulate MNEs at the national level. Vernon (1985: 256), almost thirty years ago, recognized that taxation was one of the few areas where nation states have moved to solve these inter-jurisdictional conflicts through “a rather extraordinary web of bilateral agreements.”

Building on international relations theory, I argued that this “extraordinary web” of tax agreements had become strong enough by the 1990s to be characterized as an *international tax regime* with two purposes: to reduce both double taxation and under taxation of MNEs caused by overlapping tax jurisdictions. The regime’s norms determine which country has the right to tax (the source and/or the residence country), what the tax base should be (corporate profits, sales), and what should be done about double taxation when both residence and source countries share the right to tax. The regime’s rules are the detailed application of these norms or standards in terms of corporate income tax rates, withholding taxes, deferral, exemption, foreign tax credit rules, and so on.

## 6.2.2 Reducing the Incentives for Abusive Transfer Pricing

I believe that the current criticisms in the public press about transfer pricing are misplaced—an example of “shooting the messenger” instead of focusing on the underlying problem. The problem of abusive transfer pricing is caused by perverse incentives—set in place by national tax authorities—that encourage MNEs to manipulate transfer prices to take advantage of differences in tax rates across jurisdictions. This is not a transfer pricing problem but an international tax regime “design” problem, that is best handled by fixing the source and residence rules in the international tax regime. If governments, NGOs, and the general public do not like the way that multinational firms are allocating their taxable income among countries and the amounts of tax (or lack of tax) they are paying, the problem should be laid at the feet of governments, not the MNEs. A simpler international tax regime—one based on residence taxation of worldwide income as earned with foreign tax credits for source-based taxation—or a regime with stronger anti-abuse (e.g., CFC) rules would eliminate most of the incentives for abusive behavior that riddle the current system. The prescription should be: *Physician heal thyself!*

While there will always be firms that will push the envelope in terms of tax aggressiveness—moving across the “bright line” from tax avoidance into tax abuse and possibly tax evasion—the majority of MNEs pay their taxes and follow the rules laid down for them by national governments. However, the international tax system has gaping holes that provide many legal opportunities for MNEs to engage in regulatory arbitrage. Moreover, the rules are becoming ever more complicated, both in terms of the length and variety of regulations, making it ever more difficult for MNEs to keep up with national regulations.

To end abusive transfer pricing, the first step must be to reduce the incentives for MNEs to engage in these income-shifting activities. Home country governments should tax foreign source income on a worldwide basis as earned, with no deferral provided for income kept offshore. Common residency definitions should be adopted so that MNEs cannot exploit differences in definition (e.g., Ireland versus the United States) so as to become stateless and tax free. MNEs must provide much better information about their activities, both by country and by line of business, in their public reports. Stronger anti-avoidance rules for activities with no business purpose would also provide a backstop against the most egregious activities. Greater transparency in MNE operations on a worldwide basis would also go a long way to reducing opportunities for income shifting. In sum, the first problem associated with transfer pricing—income shifting through abusive transfer pricing—I see as an “income tax design” problem, not a transfer pricing problem. The solution is to re-establish the international tax regime (Eden, 1998, 2009).

The OECD's base erosion and profit-shifting (BEPS) initiative (OECD, 2013a, 2013b) has curtailing abusive transfer pricing as one of its key goals. The OECD's proposals do not change the fundamental division of taxing rights between home and host countries (the separate entity and water's edge principles remain intact); rather, gaps or holes in the tax system that provide opportunities for under taxation of MNE worldwide profits are to be curtailed or eliminated (OECD, 2013a). OECD (2013b: 47–8) identifies several gaps or "pressure areas" that must be addressed (hybrid mismatch arrangements, the digital economy, intragroup financial transactions, transfer pricing, anti-avoidance measures, and harmful tax practices); OECD (2013a) proposes fifteen action items to address these pressure areas. The thrust of the BEPS initiative is towards strengthening the anti-abuse aspects of the international tax regime, rather than engaging in a fundamental overhaul. The success or failure of this enterprise remains to be seen.<sup>4</sup>

### 6.2.3 Transfer Pricing Regulation: A Regime within a Regime

Within the international tax regime is a sub-regime, which I have called the tax transfer pricing regime (Eden, 1998, 2009); its core norm is the arm's length standard (ALS). The history of the arm's length standard has been well surveyed already (see Eden, 1998; Picciotto, 1992) so I will only briefly highlight the dates here.

At the international level, the draft model tax treaty published by the League of Nations in 1933 was based on the "independent persons" test in IRC Section 45. The arm's length standard was included in article 9 of the draft model tax convention in 1963 and formally adopted in 1977, as follows:

Where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those that would be made between independent enterprises, then any profits which would, but for these conditions, have accrued to one of the enterprises but, by reason of these conditions, have not so accrued, may be included in the profits of that enterprise, and taxed accordingly.

The first set of *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* were issued by the OECD in 1979, building closely on the

<sup>4</sup> Useful commentaries, with different perspectives, on BEPS can be found in Boidman and Kandev (2013) and Picciotto (2013). Boidman and Kandev (2013: 1032) argue that none of the BEPS issues is new or novel, and that "any concerted fundamental changes to international tax law" are "unlikely." Picciotto (2013), on the other hand, sees BEPS as representing a fundamental shift in the OECD's focus, from preventing double taxation to preventing double non-taxation of MNE profits. Picciotto does not expect radical changes either, however, because of political obstacles and flaws inherent in the "separate entity–water's edge" approach to taxing MNE profits.



IRS Regulations. Major updates were published in 1995 and again in 2010 (see OECD, 2010). The OECD is now almost continuously engaged in rewriting and updating the guidelines (see, for example, OECD 2013c).

In US tax law, the ALS dates back almost 100 years. In 1917, the IRS Commissioner in Internal Revenue Code (IRC) Section 41 was authorized to allocate income and deductions among affiliated corporations. The Revenue Act of 1928 in IRC Section 45 added two rationales for reallocating income: the IRS Commissioner was authorized to allocate income and deductions among related corporations so as to prevent tax avoidance and determine the true taxable liability of the related parties. In 1935, the arm's length standard was introduced: the true net income of related parties should be determined so as to place them in tax parity with unrelated parties.

Section 45, renamed in 1954 as Section 482, remained largely unchanged until the US Congress added a one-line sentence in 1986 requiring that the income from a transfer or license of an intangible be "commensurate with the income" (CWI) attributable to the intangible. This change was added to ensure that intangible assets (e.g., patents) transferred by US MNEs to their offshore affiliates received, in return, royalty payments that reflected the income earned offshore by their affiliates.

While the statute has seen little change over the years, the IRS Regulations, on the other hand, have gone through multiple iterations, each edition much larger than the previous one; with the two major versions finalized in 1968 and 1994. The 1968 regulations recommended three methods for determining an arm's length price; the first method, the comparable uncontrolled price (CUP) method, was preferred because it determined the price of the related party transaction based on comparable arm's length transactions. Where there were no external market prices available, the regulations recommended valuing the functions of the simpler of the two related parties: either the distributor/buyer (the resale price method) or the manufacturer/seller (the cost plus method).

In response to addition of the CWI sentence to IRC section 482, new Treasury Regulations were finalized in 1994 that expanded the recommended list of methods to include the Comparable Profit Method (CPM) and (as a last resort) the Profit Split method (PS). The Regulations have continued to grow as IRS has wrestled with applying the CWI standard to intangibles (both transferred and co-developed) and intragroup services. The Regulations now apply the arm's length standard to goods (tangibles), services, intangibles (both transfers and development of intangibles), loans, and other forms of intra-firm transactions.

#### **6.2.4 Current Transfer Pricing Rules**

Current transfer pricing regulations and the OECD Transfer Pricing Guidelines require MNEs and tax authorities select the "best method" for pricing

intra-firm transactions. The best method is the one that generates the *most reliable measure of an arm's length result*. The basic starting point for determining the best method is a functional analysis of the MNE and the affiliates involved in the related party transactions of interest. Before one can identify comparable transactions involving unrelated parties, it is necessary to construct profiles of the related parties in terms of their functions, businesses, and transactions, and to understand the value chain of the MNE and the industry (so it is clear where the firm sits within the industry). A functional analysis in effect provides a "road map" of the multinational enterprise—its structure, strategies, activities, assets, and flows.

After a functional analysis has been performed, the next step is the identification and analysis of comparables. Comparability takes into account five factors: characteristics of the property or services; contractual terms; functions, assets, and risks performed by the parties; economic conditions of the market; and any special circumstances such as business strategies (e.g., market penetration). Any transactions between the MNE and unrelated parties that are the same or similar to the related party transactions are highlighted as possible internal comparables. To search for external comparables, it is typical to search computerized databases of firms (e.g., Compustat, Amadeus, ktMINE) and/or commodity exchanges (e.g., the London Metal Exchange) to determine whether there are comparable open-market transactions between unrelated parties. Detailed analysis of the comparables is performed, both for the transaction and the firms involved; where there are differences adjustments are made to improve their reliability.

The OECD Transfer Pricing Guidelines and national tax regulations identify a number of methodological approaches for determining arm's length transfer prices. In order to select the "best method," one must consider the economic justification that underlies each method, the conditions where each method applies, and what types of comparability are most important for each method. The three key factors in selecting the best method are (1) comparability, (2) data quality, and (3) reliability of assumptions used in each method; that is, the goal is the most reliable measure of an arm's length result.

The most basic and best known of the transfer pricing methods is the comparable uncontrolled price (CUP), which is directly derived from the definition of the arm's length standard. CUP determines the transfer price by finding an open market price for the same or similar product transacted between unrelated parties under the same or similar facts and circumstances as the related parties. The comparable transaction could be between two unrelated firms (an external comparable) or between one of the two related parties transacting with a third, unrelated party (e.g., affiliate A sells product X to affiliate B and also to unrelated party C, or affiliate B buys X from unrelated party D). In practice, CUP can be very difficult to implement because similar transactions involving similar products trading between



unrelated parties can be difficult to identify, especially for new products or intangible assets.

There are two function-based transfer pricing methods, resale price and cost plus, which can be in cases where there are no good CUPs or where a function-based method provides the most reliable measure of an arm's length result. These methods are also referred to as gross margin methods because they compare the gross margin or markup of a related party with those of comparable firms. The tax regulations recommend focusing on the simpler of the two parties, in particular, the party with little or no intangible assets, as the "tested party." The functions, assets, and risks of the tested party are then identified and measured. Through a search for comparables, the gross margins or markups earned by a carefully selected group of firms that are seen as performing comparable functions to the tested party are identified and serve as the basis for determining the gross margin/markup of the tested party. The transfer price can then be determined that is then assigned to the intra-firm transaction.

There are also two profit-based methods. The most commonly used method is the comparable profits method (CPM), which was introduced into the US transfer pricing regulations in 1994. (The OECD Guidelines have a slightly different variant called the transaction net margin method.) CPM is calculated in a manner similar to that for the gross margin methods, but bases its comparison on operating profit margins/markups (after operating costs) rather than gross margins/markups (before operating costs). The key is to compare the operating profits earned by the tested party to "normal" returns earned by comparable firms for comparable activities in the same industry.

The less well known of the two profit-based methods is the profit split method. There are two forms of profit splits; one involving total profits, the other residual profits after returns for routine functions, assets, and risks have been paid to each party. In the residual profit split method (RPSM), the first step is that each party is allocated sufficient profit to provide it with a basic (or routine) return appropriate to the functions it performs and risks it assumes. Normally, the basic return would be determined by the market returns received by similar transactions by independent enterprises under the same facts and circumstances as the related parties. Any remaining profit is considered to be the value associated with intangible assets. In the second step, this residual profit (or loss) is allocated among the parties using an allocation key; the US transfer pricing regulations recommend an allocation key based on relative contributions to intangible property.

In addition to specific guidelines on transfer pricing methods, an important procedural innovation added in the early 1990s has been the advance pricing agreement (APA) as a risk-mitigation strategy for MNEs. An MNE can request an APA with tax authorities and work collaboratively to develop a transfer pricing policy that is mutually agreeable. APAs will cover certain

transactions over a specified number of years, including both prior and future years. The APA program “is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial process. While the APA process goes on behind closed doors, some governments do release annual statistics on their APA program. The APMA Office within the US Treasury, for example, reports annually to Congress with a summary of the APAs concluded, renewed, or revoked during the previous year, with a summary of the transaction types and methods used.<sup>5</sup> In addition, APAs can be negotiated bilaterally between the two governments and the MNE, although the process typically takes a year longer to negotiate.

### 6.2.5 The Lack of Comparables

The ALS requires that transfer prices be set based on the prices that independent parties negotiate for the same or similar product under the same or similar facts and circumstances as the related parties. The criterion is: *What would independent enterprises do (WWIED?)*

#### 6.2.5.1 The Lack of Comparables in Theory

A core problem, highlighted by almost all transfer pricing professionals is that MNEs and independent entities are very different organizational forms. It is commonplace now to say that the MNE is an integrated enterprise where “the whole is greater than the sum of the parts.” Critics of the arm’s length standard regularly point to the integration economies and greater efficiencies of the MNE compared to unrelated parties as the primary reason why the arm’s length standard cannot work.

Being a multinational enterprise offers a variety of advantages compared to a domestic firm. These benefits derive partly from *internalization* (Buckley and Casson, 1976), that is, the substitution of intra-firm or related party transactions (the internal market or hierarchy) for arm’s length transactions (the external market). The reason why internalization creates benefits that are unavailable (or less available) to open market transactions is that the goals of the trading partners change; this change not only makes a big difference in firm behaviors, but also has different legal implications for MNEs and domestic firms. The goals of parties to an intra-firm transaction are cooperative—their purpose is to maximize joint MNE profit—whereas the goals of arm’s length parties when they trade are conflictual—their purpose is to maximize

<sup>5</sup> <<http://www.irs.gov/pub/irs-drop/a-13-17.pdf>> accessed 15 July 2015.

individual profits. In effect, MNE subunits collude rather than compete in the market. Internalization creates opportunities for collusion among MNE subunits, allowing them to take advantage of differences between countries in ways that unrelated parties cannot. Moreover, when unrelated firms collude, they can face legal challenges as cartels, anti-competitive behavior, and/or price fixing since competition laws in most countries outlaw collusive behavior between unrelated firms. Internalization therefore provides both economic and legal opportunities for value creation through intra-firm transactions that are not available in arm's length transactions.

Internalization benefits can be broken down into two broad categories: those that arise from natural market imperfections and those from structural market imperfections (Rugman and Eden, 1985). In terms of natural market imperfections, perhaps the best known are transaction costs in the form of market-making costs, both *ex ante* costs (search, negotiation, monitoring) and *ex post* costs (dispute settlement) due to joint control, better information sharing and higher levels of trust. MNEs also reap greater efficiencies in terms of smoother and easier coordination of flows along the value chain; for example, MNEs can transfer tacit resources such as non-codifiable knowledge more effectively between related parties than between arm's length firms; internalization therefore facilitates cross-border transfer of intangible assets.<sup>6</sup> MNEs also reap economies of scale at the firm level (centralization of functions that offer firm-wide economies of scale through pooling (e.g. accounting, marketing, finance, foreign exchange)), economies of scope where inputs produced for one activity (including R&D) can be used in more than one line of business, and economies of learning (diffusion of best practices throughout the organization, demonstration effects).

MNEs can also reap internalization benefits that arise from *structural market imperfections*; chief among these are the gains that come from cross-border arbitrage. MNEs can arbitrage their activities, taking advantage of differences in factor prices and endowments across countries, putting stages of the production chain such as processing, assembly, and sales where they offer the greatest net value added for the MNE. MNEs can take advantage of differences in product prices by engaging in price discrimination across markets. MNEs also have opportunities for regulatory arbitrage, that is, taking advantage of differences in government policies across countries by, for

<sup>6</sup> These gains are particularly noticeable when one compares an international R&D alliance consisting of arm's-length firms compared with an MNE that has multiple R&D centers. The aim of both organizational forms is knowledge sharing and knowledge creation. However, each international alliance partners must worry about knowledge leakage and appropriation by the other partners, which generates tension between knowledge sharing and fears of knowledge appropriation. As a result, either the amount of knowledge generation will be lower and/or the costs of managing the alliance higher than for related parties within an MNE. Perhaps it is not surprising that knowledge generation is seen as the competitive advantage of MNEs.



example, shifting activities and profits to less taxed or regulated locations (Rugman and Eden, 1985; Eden, 1998). The opportunity to raise global after-tax profits by using transfer pricing to engage in regulatory arbitrage between countries has been a major concern of national tax and other regulatory authorities for many decades, one that prompted the development of the arm's length standard (Picciotto, 1992; Eden, 1998). MNEs can also create structural market imperfections by exercising monopoly/monopsony power in product and factor markets (larger size implies more bargaining power); thus generating higher revenues and/or lower costs compared to arm's length parties.

Thus, integration economies come from several directions, and there have been only limited attempts by policymakers and scholars to try to unbundle these synergies. Perhaps the first approach to understanding these synergies was the identification of the *continuum price problem*, which recognized that the cost plus and resale price methods, the first based on pricing functions, assets and risks of the manufacturer/seller and the second on pricing functions provided by the distributor/buyer, left a pool of residual profits (Eden, 1998). Having given returns to the routine functions, assets, and risks of the two related parties, profits remained to be distributed. These profits were assumed to arise from intangible assets held by one or both parties, but could also be caused by synergies between them.

#### 6.2.5.2 *The Lack of Comparables in Practice*

I have argued that the real problem with the arm's length standard is the lack of comparables. The ALS suffers both from a theoretical perspective (there cannot be true arm's length comparables because MNEs are integrated businesses) and a practical perspective (finding comparables is time consuming, expensive, and for many types of intra-firm transactions and locations simply impossible).

Particularly difficult are situations where both related parties to the transaction have valuable intangible assets that are not traded on the open market so the CUT (comparable uncontrolled transaction) method using a royalty-rate database such as ktMINE cannot be used. How can one price intellectual property not traded on the open market? What does one do when markets are missing or imperfect? A more complex problem occurs when an MNE has several R&D centers scattered around the world where the R&D centers co-develop technologies that are shared by the group. How should the downstream profits from exploiting these technologies be divided among the MNE group?

From a practical perspective, the comparability problems arising from synergies and intangibles have been addressed in, I believe, four ways.

The US Treasury White Paper (1988) was perhaps the first policy document to suggest how synergies should be handled in the transfer pricing regulations, and therefore in practice. The BALRM (basic arm's length return method) followed a residual profit split method, with the residual being allocated to the parent; thus, BALRM in effect allocated all the synergies to the parent firm. There are good arguments, of course, to allocate synergies to the parent; as the entrepreneurial unit and seat of management of the MNE—the firm that created, oversees, and runs the MNE group—the synergies could rightfully be claimed by the parent.

The co-development of intangibles was recognized early on as a problem; cost sharing and cost contribution arrangements have been allowed under transfer pricing regulations since the 1960s. Typically, the parties engaged in co-development of intangible property allocated the costs among themselves in proportion to their reasonably anticipated benefits from the arrangement. A party expecting, for example, 60 percent of the benefits from the arrangement had to share in 60 percent of the direct and indirect costs. Buy-in and buy-out arrangements were added to cover situations when a related party either was added or dropped from the group.

A third policy example appears in the OECD's Chapter IX on restructuring with its focus on pooling arrangements such as central purchasing (OECD, 2010). These arguments also appear in the 2013 OECD's proposed revision to the intangibles chapter (OECD, 2013c). Where external prices are not available, the OECD recommends dividing the profits among the related parties in the MNE group based on an assessment of (1) the legal and contractual rights and obligations; (2) the economic substance in terms of the parties' functions, assets, and risks; and (3) the relative bargaining power of the parties, taking into account their realistically available options and alternatives (including make-it-yourself, the status quo and the ability to walk away). There is no "right" answer that works all the time; rather, the answer differs for each case because the facts and circumstances matter. Legal title alone is not sufficient to guarantee a related party any share in MNE synergies; the allocation among the group members depends on an analysis of the facts and circumstances.

The last place where the complexities of synergies and intangibles have been addressed in the regulations is the residual profit split method (RPSM). Under RPSM, all parties receive routine returns for their functions, assets, and risks. The remaining profit (or loss) is assumed to flow from non-routine intangible assets. Typically, the residual in fact would include all forms of synergies and intragroup efficiencies that may or may not belong to intangible assets. In RPSM involving co-development of intellectual property by two or more R&D centers, the residual is normally allocated among the parties based on either the capitalized value, or a rolling average, of the parties' R&D spending. While spending on R&D may make some sense as an allocation mechanism for profits from intangible assets, it is well known that income (revenue) derived

from intangibles is not directly linked to the costs of R&D development. The allocation key appears to be even less appropriate when the residual profits include all synergies, not just returns to non-routine intangible assets.

### 6.2.6 Reform Proposal: Fine-tuning the Arm's Length Standard

The problems with implementing the arm's length standard are real problems, ones that have been known for a very long time. Addressing the workability of the current ALS rules in the context of twenty-first century MNEs does require retooling current transfer pricing practices. My recommendations here are directed at reinvigorating—rather than replacing—the arm's length standard. Box 6.1 below provides some suggestions.

The key thrust of my argument is that *facts and circumstances matter*. The best transfer pricing method is the one that most closely fits the facts and circumstances of the particular situation. The economic substance behind the MNE's transactions and activities should matter more than mere legal title. The functions performed, assets provided, and risks assumed—as outlined in a functional analysis—must be the critical foundation for understanding the economics and business aspects of the MNE. Thus, it is critical for tax authorities to have a *holistic* approach to understanding the MNE.

Saying that transfer pricing requires a holistic approach based on a deep understanding of the MNE's activities, however, is different from putting this statement into practice. Moreover, MNEs with their knowledge of the inside workings of their own group will be much better placed to understand their facts and circumstances than will national tax authorities that do not have access to this level of detailed information except in special circumstances such as an Advance Pricing Agreement (APA).

For situations where comparables do exist in the external market, the comparable uncontrolled price (CUP) method (or CUT for intangibles and CUSP for services) has clear advantages over the other methods: it is two-sided and transaction-based. Adjustments can be made for differences in comparability of products, contract terms, and so on.

Where external prices are not available, I am supportive of the approach advocated by the OECD in its 2010 *Transfer Pricing Guidelines* Chapter IX on restructuring, its 2013 draft chapter on intangibles (OECD, 2010, 2013c), and in its 2013 BEPS action plan stating that transfer pricing outcomes should be in line with value creation (OECD, 2013b: 20). Profits should be divided among the related parties in the MNE group based on an assessment of (1) each party's legal and contractual rights and obligations; (2) the economic



**Box 6.1 Recommendations: Lack of comparables—focus on the facts and circumstances****Fine-tuning the methods**

- 1 Stress facts and circumstances—economic ownership should matter more than legal title.
- 2 Emphasize the role of economic substance (the functions, assets, and risks) and the value created or contributed by each related party in the MNE group.
- 3 Move away from one-sided transfer pricing methods (resale price method, cost plus method, CPM/TNMM) in favor of methods that take all the related parties into account (CUP).
- 4 Re-establish the commitment to CUP (CUT for intangibles, CUSP for services) as the preferred transfer pricing method when comparables exist and adjustments can be made for non-material differences.
- 5 Pooling and co-development arrangements are here to stay. MNEs can reap economies of scale, scope, and learning by pooling their resources and costs. We need better methods for allocating the savings from pooling among the group members, and the firm playing the “entrepreneur” and “manager” roles (where one exists). Allocation keys should be based on value creation by the group's members, not on costs spent.

**Fine-tuning the process**

- 1 Require more detailed information on the MNE's activities through combined and country-by-country reporting (CaCbCR) and reporting by line of business.
- 2 Encourage automatic on-request information exchange among tax authorities.
- 3 Expand and streamline the Advance Pricing Agreement (APA) program, including bilateral and multilateral APAs.
- 4 Provide more public information on APA outcomes including publication of “best practice” templates based on Advance Pricing Agreement (APA) settlements that can be adopted by other MNEs and tax authorities.
- 5 Increase opportunities for binding arbitration of international transfer pricing disputes.
- 6 Encourage joint audits by tax authorities where MNE activities are deeply intertwined across borders.

substance in terms of the parties' functions, assets, and risks; and (3) the relative bargaining power of the parties, taking into account their realistically available options and alternatives (including make-it-yourself, the status quo, and the ability to walk away). There is no “right” answer that works all the time; rather, facts and circumstances matter.

While in general I favor two-sided over one-sided methods, I recognize that any method has great difficulty in allocating the returns to synergies and high-value intangibles among the MNE group. Cost sharing arrangements (CSAs) are difficult, for example, because intragroup transfers must be calculated each time a related party enters into (buy-in) or exits from (buy-out) a CSA, as evidenced by recent changes in US CSA regulations in light of the Veritas and Xilinx transfer pricing court cases.

Profit splits are also difficult because the current keys used to allocate profits among the entities are based on historical cost shares, not on their reasonably anticipated benefits from these activities. Arm's length parties are unlikely to

agree to split the profits from their activities based on cost shares, in cases where the distribution of benefits between them is unrelated to their distribution of costs. Finding better metrics for allocating profits among the members of an MNE group is therefore a critical component in transfer pricing reform.

Formulary apportionment methods typically use a three-part formula based on sales, assets, and wages as the allocation key. However, this formulary approach exactly misses the point: the difficulties in dividing up profits among the members of an MNE group are caused by synergies and unique intangibles that have no open market comparisons. Source-based measures (capital and labor) and destination-based measures (sales) are probably preferable to simply using costs, but still do not get at the proper allocation of "beneficial economic ownership" inherent in intangibles and synergies within the MNE group.

Fine-tuning the transfer pricing process can also be a useful reform. I support the provision of more information about the MNEs activities, such as Combined and Country-by-Country Reporting (CaCbCR). I also support more automatic information exchange between tax authorities, and the adoption of international standards in terms of contemporaneous documentation. In situations where the activities of an MNE are deeply intertwined in two or three countries (such as the auto industry in Canada, the USA, and Mexico) joint tax audits could also be considered. The Advance Pricing Agreement (APA) program also needs expansion and streamlining, with more information provided on best practices so that other MNEs and governments can benefit from these "closed door" proceedings.

## 6.3 DISCUSSION

### 6.3.1 Other Policy Alternatives: Formulary Apportionment

Many, many pages have been written reviewing the pros and cons of the arm's length standard (ALS) versus formulary apportionment (FA) as methods for taxing multinational enterprises (MNEs). It seems to me that the ALS approach is here to stay, at least for the foreseeable future. In this paper, I therefore chose not to review the pros and cons of the two approaches, nor make arguments for why one should replace the other, but rather have focused on how to improve what we have now.

It does look like the European Union member countries are going to introduce a Common Consolidated Corporate Tax Base (CCCTB). This will provide MNEs, their accounting and legal advisors, policymakers, and academics with the opportunity to watch how a FA system works in a multilateral context. Just as the NAFTA was the first free trade agreement to include both

developed and developing countries, and proved that it was possible to establish a north-south free trade agreement, perhaps the EU's introduction of a CCCTB will have a similar demonstration effect.<sup>7</sup> A regional FA system means that the EU member countries must continue to use the ALS for their transactions with non-member countries; how national governments handle these complexities will also be telling.

Our historical experience with FA systems to date has been at the state level within countries, where the federal level of government enforces some consistency in terms of norms, rules and procedures. Moreover, the states within a federal system all operate under a common currency, monetary, fiscal, and international trade policies; a FA system should be more difficult to coordinate where these macro-level policies differ. Hammering out these complexities will provide useful lessons for other countries, both rich countries and developing countries, which contemplate a move from a SA-ALS to FA system.

### 6.3.2 Obstacles to Reform and Solutions

I believe there are two problems with current transfer pricing regulation: abusive transfer pricing and lack of comparables. I see abusive transfer pricing as a design issue (that is, how to improve the efficiency and effectiveness of the international income tax regime). The lack of comparables, on the other hand, is a problem integral to the theory and practice of the arm's length standard.

There are two key obstacles to reform of the arm's length standard. The first obstacle arises from the parties "at the table" when transfer pricing rules and guidelines are being written. Because the topic is so esoteric, only a few individuals are well-enough informed to participate knowledgeably in the debate. For example, the OECD has multiple working parties involved in overhauling the transfer pricing guidelines and the BEPS initiative; the working parties consist of three groups: tax authorities, MNEs, and tax consultants. The United Nations (2013) has also recently released a *UN Transfer Pricing Manual*, which pays closer attention to the situation of developing countries and their tax authorities; the manual was primarily developed by developing country tax authorities with inputs from MNEs and tax groups. The parties at the table (MNEs, tax authorities, and transfer pricing professionals) have their own vested interests in the outcome.

In terms of solutions, I see NGOs as having an important role to play here in providing a counter-weight to MNEs, particularly through their information dissemination activities. The Tax Justice Network, for example, has been influential in raising public awareness of trade mispricing and its harmful

<sup>7</sup> On the other hand, the experiences of Greece, Portugal, and Spain as members of the euro suggest that the road to integration is not always a smooth one.



impacts on developing countries. While I disagree with those NGOs that see all transfer pricing as abusive, these groups have been instrumental in providing data and case studies supporting the OECD's base erosion and profit shifting initiative (Christian Aid, 2009). Recent work by the World Bank (see Reuter, 2012) has also drawn attention to the problems that can occur if MNEs engage in transfer pricing practices that drain income from developing countries. I argue that academics can also play a useful non-partisan role, particularly in terms of providing an economic analysis of the various proposals.

The second obstacle is a longer-run problem. Transfer pricing problems are inherently puzzles; as such they require puzzle-solving, logic-building skills. They also require understanding the MNE—like an elephant—from multiple perspectives including accounting, business, economics, finance, politics, and law. As a long-run solution to the problem—one that I not surprisingly support as an educator—we need to provide college and university students with training about related party transactions, transfer pricing, and international tax laws.

Very few places in the world offer any kind of training on these topics; most practitioners learn “on the job.” As such, they learn practical skills, short cuts, and rules of thumb. While useful, I believe that these tools need to be accompanied by solid training in the fundamentals of international tax law, the economics of international business, and the strategies of multinationals. Transfer pricing reform should be guided by the same principles that guide good international tax reform. To understand the facts and circumstances that underlie the MNE's intra-firm transactions one needs economic analysis. Lastly, a thorough understanding of the twenty-first-century multinational as an organizational form—its strategies and structures, core competencies, and value-adding activities—is required if we really want to understand the “elephant” among us.

## 6.4 CONCLUSION

The historical approach to taxing intra-firm transactions of multinational enterprises—the arm's length standard—has been criticized as unworkable, out of date, and on death's door. Many academics (including some in this volume) are advocating a shift to formulary apportionment as an alternative. My view is two-fold. First, many of the criticisms of the arm's length standard in terms of abusive transfer pricing are misdirected; the criticisms should be more appropriately aimed at weak international corporate income tax rules that need to be fixed. Second, if the loopholes in the international tax regime can be fixed, the arm's length standard remains the appropriate

standard for taxing MNEs. The standard does require fine-tuning—the twenty-first-century multinational is not the same organizational form as the twentieth-century MNE—and I offer a few policy recommendations with that goal in mind.

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