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## David and the Three Goliaths: Defending the Arm's-Length Principle

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### ARE 'OLD RULES DUMB ANYWAY?'

How many rules have “gone out the window” since the COVID-19 pandemic began shutting down the world economy in early 2020? NPR’s Planet Money broadcast on August 28, 2020 answered, “Lots — but the old rules were dumb anyway.” On the 85<sup>th</sup> anniversary of the arm’s-length principle (ALP), with no end in sight to the pandemic, I fear that the ALP together with its finetuned transfer pricing rules and procedures so painstakingly developed over those 85 years may also meet the same fate: “The old rules were dumb anyway.”

The ALP is already in a weak position. In 2019, the OECD — historically the single strongest supporter of the ALP — did an “about face,” recommending that the ALP be replaced by global formulary apportionment (GFA) in order to shift the global profits of multinationals away from residence and source jurisdic-

tions to the so-called market jurisdictions.<sup>1</sup> This summer, revised proposals for taxing the digital economy were issued by the OECD and United Nations, leading Treidler<sup>2</sup> to argue that both international organizations were “walking together into the formulary apportionment abyss.”

Like Treidler, I fear that the OECD and UN are walking away from the ALP and into a GFA abyss. My purpose in this article is to look back — and look forward — at the criticisms that have been levied at the ALP, which I argue can be grouped in three categories — two old, one new. Drawing on the Biblical story of “David and Goliath,” I argue that all three criticisms (Goliaths) can be felled by the ALP (David) — if we use the arrows of logic, economics, and pragmatism. My goal is to show that the old rules are NOT dumb; we need to walk back from the GFA abyss. The ALP is still, and needs to remain, a valuable and core component of the international tax system.

### GOLIATH #1: ABUSIVE TRANSFER PRICING

The first Goliath, abusive transfer pricing, argues that multinational enterprises have been deliberately engaging in extensive and unfair transfer mispricing that is especially harmful to developing countries. I believe this criticism is an example of “shooting the messenger.” Abusive transfer pricing is caused by perverse incentives — set in place by governments — that encourage multinational enterprises to manipulate transfer prices to take advantage of regulatory arbi-

\* This article is drawn from on my presentation, “David and the Three Goliaths: Defending the Arm’s Length Principle,” given at the Third Annual Transfer Pricing Conference hosted virtually by Panamerican University on 14 August 2020. See <https://youtu.be/RgTXGFmYn5U>. In my talk and this article, I follow the OECD and UN, using the term “arm’s length principle (ALP),” rather than the North American (and my preferred) term, “arm’s length standard (ALS).”

<sup>1</sup> See, e.g., Lorraine Eden and Oliver Treidler, *Taxing the Digital Economy: Pillar One Is Not BEPS 2*, 48 Tax Mgmt. Int’l J. 603 (Dec. 13, 2019). Lorraine Eden, *The Arm’s-Length Standard Is Not the Problem*, 48 Tax Mgmt. Int’l J. 499 (Oct. 11, 2019).

<sup>2</sup> Oliver Treidler, *Are the U.N. and OECD Walking Together into the Formulary Apportionment Abyss?* Tax Notes Int’l (Aug. 31, 2020), pp. 1191-1194.

trage opportunities such as differences in corporate income tax (CIT) rates across jurisdictions. International tax regime design problems are best handled at that level, by fixing the gaps in international tax system rules, rather than by replacing the ALP by GFA. My assessment is that the OECD's BEPS (Base Erosion and Profit Shifting) project has gone a long way to addressing the most egregious of these tax loopholes. Early results by the OECD (18 July 2020), e.g., country-level adoptions of the BEPS Action Items and the growth in international cooperation and coordination among tax authorities, suggest that the BEPS reforms are working.<sup>3</sup> This is a "good news story" and the OECD is to be congratulated for its successes, which will grow stronger as more countries adopt the BEPS reforms.

## **GOLIATH #2: ABSENCE OF COMPARABLES/PRESENCE OF SYNERGIES**

The second Goliath, the absence of comparables and presence of synergies, argues that transfer pricing rules do not work in theory and are too difficult to implement in practice. The reasoning behind this criticism is that arm's-length comparables are difficult to find or non-existent and that multinationals benefit from synergies not available to unrelated parties. My response is that transfer pricing professionals need to go back to basics, to focus on the spirit of the ALP and the economics underlying the transfer pricing methods, and fine-tune them for today's realities.

Moreover, I believe that the GFA proponents who want to replace the ALP as the norm for allocating worldwide MNE profits among tax jurisdictions are mistaken. GFA looks easy on paper, but "the devil is in the details." GFA would surely create more problems than it solves. The largest and longest running experiment with GFA is the interstate compact to allocate CIT revenues among 15 of the 50 U.S. states. The results are not encouraging. Even at the subfederal level, the U.S. interstate compact has been riddled with tax competition games. The amount of tax revenues raised and allocated by GFA is "peanuts" (less than 4% of state tax revenues, according to HowMuch.net). Replacing the ALP with GFA, as proposed in the OECD Secretariat's Pillar One "Unified Approach" to taxing the digital economy, makes little sense given the limited and discouraging historical precedent for GFA. I therefore plead with the OECD, G20, and national tax authorities to "give BEPS a chance" before moving to adopt any form of GFA as part of their tax-the-digital-economy proposals.

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<sup>3</sup> *OECD/G20 Inclusive Framework on BEPS: Progress Report July 2019-July 2020* (18 July 2020).

## **GOLIATH #3: THE ALP CANNOT WORK IN THE DIGITAL ECONOMY**

The third Goliath is the newest: the criticism that the ALP cannot work in the digital economy. In a world of "scale without mass" where MNE profits come from intangible assets, data, and network effects, the OECD Secretariat has concluded that the ALP has finally met its match and needs to be replaced. My response to this criticism is two-fold. First, the ALP has shown in the past that it is a flexible and robust global standard that can move with the times, which suggests that the ALP can also accommodate the digital economy. Over the years, tax authorities have expanded their repertoire of transfer pricing methods to encompass different types of related-party transactions that have grown more sophisticated and complex (e.g., from goods to services to co-development/cost-sharing arrangements, complex global value chains, and now to cash pools and financial transactions).

Second, all evidence to date suggests that the ALP is sufficiently robust to handle the "high-surprise, high-threat, short-time" crisis of a once-in-100-years global pandemic and accompanying economic recession. If existing transfer pricing methods are flexible enough to handle the extraordinary events of 2020, I am optimistic that the ALP can also accommodate the much more slowly digitalizing global economy. I therefore believe that — with logic, economics, and a dose of pragmatism — transfer pricing methods can be developed to cover the digital products and transactions of the 21<sup>st</sup> century.

Moreover, the new draft blueprints issued by the OECD for Pillars One and Two are, as VanderWolk<sup>4</sup> argues, "Rube Goldberg machines," enormously complex proposals that will, if adopted, create many opportunities for cross-border tax arbitrage games by MNEs and their tax advisors. Developing country tax authorities, in particular, do not need Rube Goldberg machines, but simpler and more effective ways to raise tax revenues.

Instead of moving forward with the Pillar One proposals, I recommend that the OECD and the UN convene committees of experts (including academic experts on digital business models) to write new chapters for their transfer pricing manuals. Some fine-tuning of existing BEPS Action Items to cope with the digital economy would also be useful (for example, broadening the definition of permanent establishments to encompass digital foreign direct investment, eliminating tax benefits for stateless income). I am also po-

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<sup>4</sup> Jeff VanderWolk, *The OECD's Draft Blueprints for Pillars 1 and 2 — Rube Goldberg Lives On*, Bloomberg Tax Transfer Pricing Report (Sept. 3, 2020), pp. 1-2.

tentially in favor of the OECD/G20's proposals for Pillar Two, a global minimum corporate income tax, assuming the tax can be designed so as to discourage the pernicious tax competition among developing countries and provide them with at least some CIT revenues to finance their economic and social development.<sup>5</sup>

## **CONCLUSION: THE ARM'S-LENGTH PRINCIPLE IS STRONGER THAN THE THREE GOLIATHS**

The arm's-length principle is sufficiently robust and flexible that it can handle all three criticisms: *The ALP*

*is stronger than the three Goliaths.* Just because the rules are old doesn't mean they are dumb or that they should be abandoned when new crises or technological changes occur. The ALP is a necessary and critically important component of a robust and flexible international tax regime — one that can be efficient, neutral, and equitable for developed and developing economies in the years ahead.

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<sup>5</sup> Lorraine Eden, *Taxing Multinationals — The GloBE Proposal for a Global Minimum Tax*, 49 *Tax Mgmt. Int'l J.* 11 (Jan. 10, 2020).