FROM ARM'S LENGTH TO VALUE CREATION TO MARKETS VS FORMULARY APPORTIONMENT

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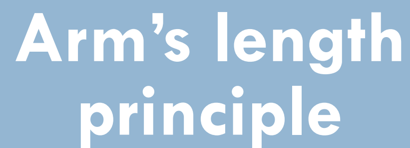
Approaches to transfer pricing



Formulary Apportionment

The Arm's length Principle

Arm's Length Principle

"The arm's length principle is an international standard that compares the transfer pricing charged between related entities with the price of similar transactions carried out between independent entities at arm's length. An adjustment may be made to the extent that profits of a related party differ from those that would be agreed between independent entities in similar circumstances."

- United Nations Practical Manual on Transfer Pricing for Developing Countries (2017)

Well recognized and accepted international principle which is the foundation of modern transfer pricing laws.

The Arm's length Principle

Advantages

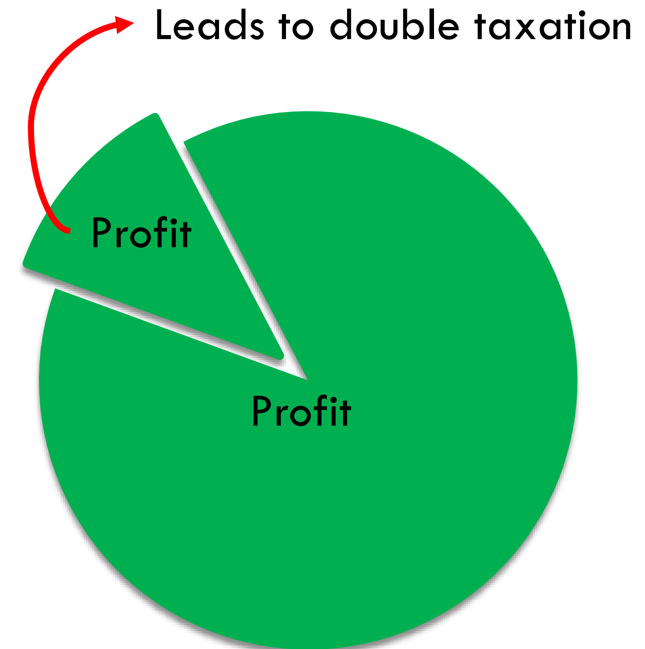
- Aim to achieve equal treatment of related and unrelated transactions
- Allowance commercial flexibility for specific business circumstances
- Potential prevention of phenomena of tax avoidance and/or aggressive tax planning
- Avoidance of double taxation and of less-than-single taxation
- Fair and balanced allocation of taxing powers between different states
- Overcome issues related to cross-border transactions
  - Compatibility with tax treaties
  - Compatibility with Indian law
- Enforceability
- Allowance of a coordinated approach
- Avoidance of conflicts between different kinds of rules

Disadvantages

- Lack of comparables – not only in developing countries, but in developed countries also
- Difficulties in its implementation
  - Separate entity approach
  - Comparability analysis
- Administrative burden
- Lack of information (in particular for developing countries or highly integrated transactions)

Challenges to ALP

- Issue with determination of ALP – you cannot tax what you cannot measure
- Shaking the Foundation – Classical economics free market
  - Tangible vs Services and Intangibles
  - Technology
  - State-sponsored Capitalism



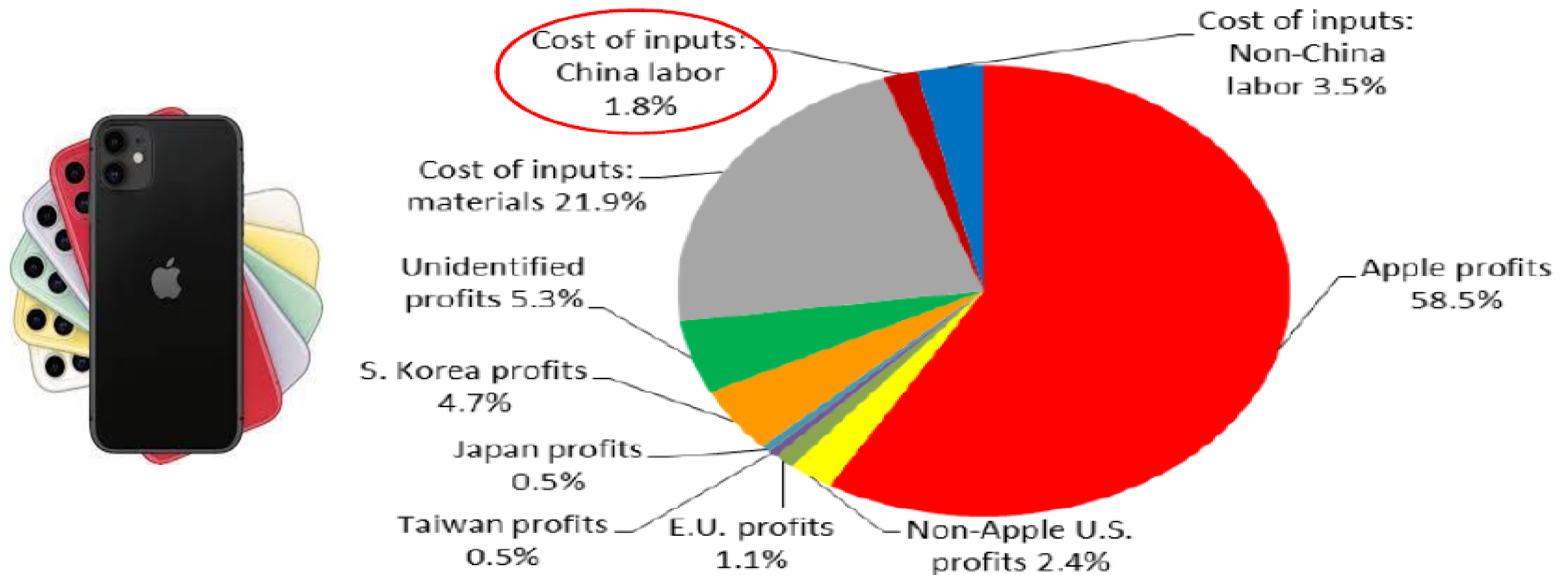
- Application of current transfer pricing laws based on ALP may not always ensure that the arm's length price reflects value created.
- The recent OECD pillar one consultation document lays bare the widespread dissatisfaction with the tax outcomes resulting from the ALP

A move towards value creation

- Align Taxation to Value Creation
  - Value Creation: *"The performance of actions that increase the worth of goods, services or even a business. Many business operators now focus on value creation both in the context of creating better value for customers purchasing its products and services, as well as for shareholders in the business who want to see their stake appreciate in value."*

    http://www.businessdictionary.com/definition/value-creation.html
- Value is created by supply side and demand side factors along the value chain
- Value is also created by Data and User Participation: A fundamental issue "Who owns the data and has intellectual property rights on it"?
- Importance of intangibles in value creation & increased digitization lead to TP & attribution related issues

Where Is The Value Created?



- Is cost plus 5-15% mark-up commensurate remuneration to the Chinese manufacturer? Or is PSM more justified? If yes, how to apply it?
- Any other method that delivers an outcome that is aligned with “value creation”?
- The tug of war continues… where *is* value created?

OECD & G20 BEPS Action Plans

*"BEPS Actions 8-10 address transfer pricing guidance to ensure that **transfer pricing outcomes are better aligned with value creation of the MNE group**. In this regard, Actions 8-10 clarify and strengthen the existing standards, including the guidance on the application of the arm's length principle and an approach for appropriate pricing of hard-to-value-intangibles within the arm's length principle."*
https://www.oecd.org/tax/beps/beps-actions/action8-10/

- A supplement to ALP concept
- Deficiencies and issues not completely addressed, only partially
- "Value" is subjective concept; contribution to value is more subjective – difficultly in measurement & quantification persists
- Only addresses cases where ALP ≠ Value Creation where value chain consists only or mainly of related parties – BEPS also takes place in cases where unrelated parties from important part of value chain
- Approach of taxing profits where value is created needs to step beyond related party transactions

FAR Analysis

- Important part of TP analysis is the consideration of the Functions performed, Assets (tangible and intangibles) deployed and Risks assumed (FAR) by the parties to the transaction.

- Important for comparability analysis & selection of method

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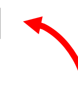


OECD

- FAR analysis is the bed-rock of concepts such as DAEMPE/ DEMPE, "Cash-Box company", "Low-Risk Distributor" etc.

- Is also relevant for profit-attribution, especially in case of PEs – but if no PE is created due to inherent deficiencies and outdated definition of PE, FAR analysis fails to prevent BEPS

FAR to FARM

- Business profits are generated by both demand side factors and supply side factors. Till now, "Market" was not given importance.
- There is a valid justification of attribution (and taxation) of profits to all jurisdictions that contribute through both supply and demand side factors.
- Therefore, in addition to consideration of FAR factors, consideration of the contribution to the profits & value creation by the market jurisdiction & factors also is to be given due weightage
- The OECD takes a pure supply side approach in its TP guidance – this is rejected by developing countries, which support a mixed approach.
- This works in determination of ALP (where relevant) but especially for undertaking profit attribution
- Deficiency under FAR of addressing BEPS where there is no PE continues

TP & Profit Attribution

- Nexus = Who can Tax vs TP = How much to Tax
  - Apportionment vs Valuation
  - Arm's Length Principle as an objective valuation method
  - Commensurate with income, fair market value
- TP applies to transactions between related parties – irrespective of nexus
- Apportionment question arises after nexus has been established – even if apportionment rules are rationalized, they would become effective & robust **only after nexus rules are modernized & upgraded**
- Concepts are linked by common objective: ALP, Value Creation, FAR, FARM and Formulary Apportionment all seek to prevent BEPS & ensure that "fair share" of tax is paid by the correct party to the correct country

Approaches to Profit Attribution

- Two major approaches are considered:
  - Formulary Apportionment – apportioning profits proportionately based on global sales and FAR factors
  - Fractional Apportionment – apportioning profits proportionately based on jurisdiction-centric sales and FAR factors
- Formulary Apportionment can work only when it is implemented globally in a standardized manner across jurisdictions
- Fractional Apportionment (chosen by India in its draft revised rules on apportionment and used widely by US in its Domestic TP) considers only data pertaining to the particular jurisdiction to ensure that profits reported there are appropriate – not concerned with under-reporting/ over-reporting in other jurisdictions. Easier to implement, but may lead to double taxation (unless other country(ies) accept the apportionment)

How would formulary apportionment work?

- Under the current global system, multinational firms determine their profits separately in each tax jurisdiction in which they operate.

- An alternative system would allocate a firm's worldwide income across countries using a formula based on some combination of its sales, assets, and payroll in each jurisdiction.

- An alternative formula would base a corporation's taxes only on the fraction of its worldwide sales destined for domestic consumers, a so-called ***"destination-based"*** corporate profits tax.

Advantages Disadvantages

- Removes current artificial incentive for multinationals to shift reported income to low-tax locations.
- Tax liabilities, instead, would be allocated by a measure (or measures) of their real economic activity in each location.
- Reduce the tax system's complexity and the administrative burden it imposes on entities.
- There would be no need for transfer-pricing rules for intra-group transactions, which would remove a major source of dispute between corporations and tax authorities.
- Controlled Foreign Corporation (CFC) rules would be redundant since all profits assigned to foreign activities would be exempt. For this reason, there would also no longer be a need for foreign tax credits.

- Difficult in designing and implementing a global formulary apportionment system.
- Such a system would create new incentives for tax avoidance and could increase the incentive to shift real investments to low-tax countries.
- It would require an agreement among the major economies to scrap the current separate-entity system and to agree on how to allocate corporate income among jurisdictions.
- It would also require agreement on common accounting methods for measuring corporate profits.
- A unilateral move by any country to formulary apportionment would result in double taxation of some multinationals' income and exemption of other income.
- Introduces new boundary problems between high-tax and low-tax activities.

Advantages Disadvantages

Advantages

- Shift to formulary apportionment can be made revenue neutral by reducing corporate tax rates.
- It would make a multinational corporation's tax liability independent of both its legal residence and its legal form (for example, branch or subsidiary).
- It would remove any incentive for corporate inversions in which firms from two countries merge and establish their residence in a low-tax country to reduce their tax liabilities.

Disadvantages

- Creates incentives to shift profits between multinationals and separately owned firms - For e.g. if physical assets help determine the location of a multinationals' profits, a firm might well have an incentive to contract its low-margin manufacturing activities in high-tax jurisdictions to independently owned firms instead of establishing a manufacturing subsidiary within the firm to reduce its share of capital assets allocated to high-tax countries.
- Could worsen the incentive to shift real activities to low-tax countries because intangible assets — a large share of value for many leading multinational companies—are part of a firm's total profits but are absent from the allocation formula.
- Some analysts and commentators favor sales or destination-based allocation of corporate profits because firms are least likely to reduce sales in a jurisdiction simply to reduce tax liability.

Return to the past?

In 1920-1923, the ICC commenced a process to develop a model income tax treaty in the immediate aftermath of World War I. This was the period of conception for the model treaties of today. This work has been lost as the world has evolved. It is instructive with respect to the current tax policies being espoused by Source Countries.

The Post-World War I World (1920 – 1923)

Imagine a world, long ago, in which the paradigm of commerce and international taxation was a developed country (let's call it "England") and an under-developed country that was a colony of England ("India"). A global war ended, with England having enormous war debt. There was a material flow of commerce between England and India. For the most part, England transferred to affiliates in India capital, technology, and access to global markets. India responded with commodities and produced goods. England was a creditor and India a debtor.

The policy issue for consideration was how income from these activities should be shared between "Resident" and "Source" countries.

Return to the past?

ICC Proposal in 1923

In its interim report in 1923, the ICC proposed what we would call today a *profit split or formulary allocation* methodology to address income allocation between Residence (Creditor) and Source (Debtor) countries.

Rather close to the combined income methodologies that we typically use today to resolve major cases between countries with an MNE in the middle. It is also similar to the methodologies for evaluating intangibles in the 2012 OECD discussion draft.

Change in course…

League of Nations (1923 – 1928)

The ICC work was taken over by the League of Nations in 1923. The LofN took an entirely different approach. It formulated 5 principles:

1. Source Country (India) should tax local operations, including property or other pertinent matters.
2. Residual income should be earned by the country of Residence, which provided the knowledge and capital for the business.
3. Presence of an interim holding company should be treated as a Residence Country. *Why was this assumed?*: All countries would adopt a common model!
4. Subsidiaries should not be treated as a PE.
5. TP is to be evaluated on a consistent basis.

The model treaties that eventually became the OECD Model, and subsequently the UN Model, are based on these 5 principles.

What was the net impact of these principles?

Answer: A system that allowed:

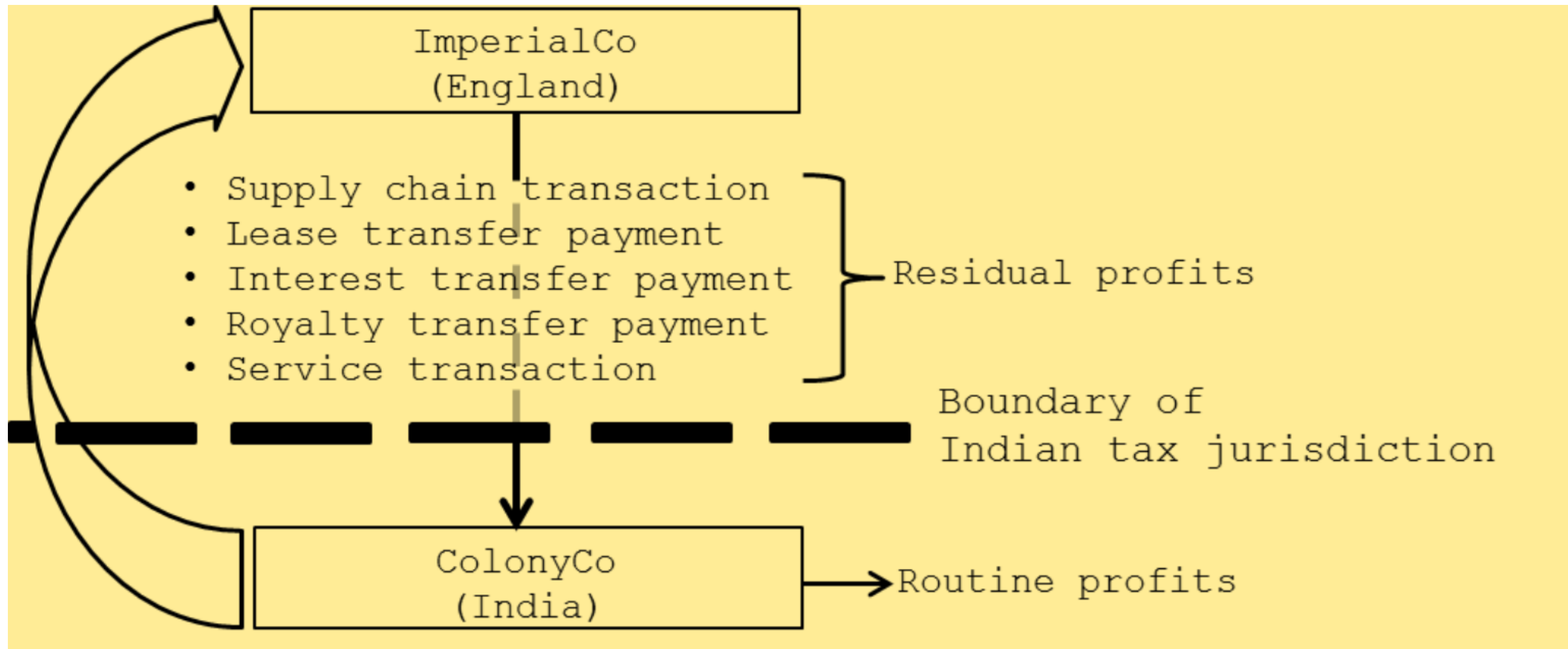
1. Source Country earns a routine return.
2. Residence Country receives the residual income.
3. Interim holding companies treated as Residence Countries, even if located in a low tax country.

Not surprisingly, the international tax and effective tax rate ("ETR") strategies of MNEs evolved based on this treaty model. Common structures included what we today describe as:

1. Global/regional principal
2. Centralized risk-taker, intangibles owner
3. Limited risk activities in high tax countries

ETR strategies are often based on easily applied one-sided TP methodologies, which typically test the earnings of Source Country affiliates. These strategies are precisely what was contemplated in the work of the LofN, which is the model of OECD/UN model treaties.

Imperial Paradigm



Today, MNEs are commonly pilloried for base stripping Source Countries.
Is the criticism appropriate? Whether this answer is "yes" or "no," it is apparent to that this is the behavior that was encouraged by the LofN model. At the time, it may have been intended to facilitate repatriation of revenue to Residence countries to repay war debts.

Where does this leave us?

- Before we consider what we're likely to see, it's worth stepping back and judging whether the G20 states, along with the wider Inclusive Framework countries, will live up to their commitment to reaching a consensus.
- The OECD's programme of works marks an important milestone in international tax reform – Pillar 1 seeks to redefine nexus rules & bring in formulary apportionment, taking us back to the ICC's original idea
- While the focus is digital business, measures such as minimum tax and reallocation of profits from where value created to where it is consumed will have a profound impact on all MNEs & also tax administrations

Earlier BEPS was ***done by*** developed economies…
Now the shoes is on the other foot, developed economies are suffering from BEPS.
So the rules need to be "upgraded" to be more "fair".

THANK YOU