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ARTICLE

BEPS: Is the OECD Now at the Gates of Global Formulary Apportionment?

Robert Robillard*

Several Base Erosion and Profit Shifting (BEPS) public discussion drafts recently released have indirectly called into question the relevance of the arm's length principle for transfer pricing and international taxation purposes. This article highlights the numerous instances where formulary-like approaches have lately been put forward by the OECD to replace the arm's length principle. Are we witnessing a major philosophical shift by the OECD?

1 Introduction

For most countries around the world, December brings the Holiday season, a joyful and festive period where gifts, wishes and pleasantries are exchanged. But as far as the Organisation for Economic Co-operation and Development (OECD) is concerned, December 2014 may very well enter into the transfer pricing and international taxation history book as the month where the gates of formulary apportionment were finally knocked over in transfer pricing and international taxation. It would seem that the arm's length principle is now slowly but surely being relegated to the back seat of the international transfer pricing rulebook that are the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[1] (OECD TP Guidelines).

The Base Erosion and Profit Shifting initiative ('BEPS initiative') is the sole culprit of that transfer pricing singularity. As a policy, the BEPS initiative has officially been ongoing since 12 February 2013 with the release of *Addressing Base Erosion and Profit Shifting*.[2] But it really took shape with the fifteen-point Action Plan titled *Action Plan on Base Erosion and Profit Shifting* released by the OECD on 19 July 2013.[3] At the time, Chapter 3 of the action plan introduced the idea that 'fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it'.[4] It further added that 'new international standards must be designed to ensure the coherence of corporate income taxation at the international level'.[5] In spite of these statements, there was no visible indication that a philosophical rampage of the fundamental beliefs behind the arm's length principle was in its infancy.

It all started with this little nugget found in the *Guidance on Transfer Pricing Aspects of Intangibles*[6] released on 16 September 2014 which in paragraph 6.57 suggested that 'because it may be difficult to find comparable transactions involving the outsourcing of such important functions [mostly the design and the control of the design of intangibles], it may be necessary to utilize transfer pricing methods not directly based on comparables, including profit split methods and valuation techniques, to appropriately reward the performance of those important functions'. It was therefore proposed that the determination of an arm's length price, in 'some situations', may be performed without direct reference to

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1 OECD (2010), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 22 Jul. 2010; online: http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2010_tpg-2010-en#page1.

2 OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing; online: *http://dx.doi.org/10.1787/9789264192744-en*.

3 OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing; online: http://www.oecd.org/tax/action-plan-on-base-erosion-and-profit-shifting-9789264202719-en.htm.

4 *Ibid.,* p. 13.

5 *Ibid*.

6 OECD (2014), *Guidance on Transfer Pricing Aspects of Intangibles*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing; online: *http://dx.doi.org/10.1787/9789264219212-en*.

the results of the comparability analysis as per Chapter I of the OECD TP Guidelines.

However, paragraph 1.33 of the OECD TP Guidelines indicates that 'application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises'. In fairness to the OECD, page 10 of the executive summary of *Guidance on Transfer Pricing Aspects of Intangibles* pointed out at the time that the shaded portion of the documents had to be 'viewed as interim drafts of guidance, not yet fully agreed by delegates, [a draft] that will be finalized in 2015 in connection with other related BEPS work'.

In that regard, intensive work on the fifteen-point action plan on the BEPS initiative recently produced a massive flood of public discussion drafts including in chronological order:

(1) *BEPS Action 10: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services.*[7]

(2) BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains.[8]

(3) *BEPS Action 4: Limit base erosion via interest payments and other financial payments.*[9]

(4) BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (*Including Risk, Recharacterisation, and Special Measures*).[10]

Other drafts recently released with respect to the BEPS initiative included in chronological order: *BEPS Action 7: Preventing the Artificial Avoidance of PE Status;*[11] *Follow Up Work on BEPS Action 6: Preventing Treaty Abuse;*[12] *BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions;*[13] and *BEPS Action 14: Make dispute resolution mechanisms more effective.*[14]

But it is indeed in the aforementioned four drafts that the OECD may well have finally lost its way with respect to the arm's length principle as far as transfer pricing goes. Fully mesmerized by the BEPS initiative, it looks like the OECD is slowly drifting away from the arm's length principle right into the arms of the global formulary apportionment mermaid for transfer pricing purposes as will be briefly chronicled below.[15]

2 The arm's length principle and the availability of comparables

First came the public discussion draft on *Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services* released on 3 November 2014. The draft was intent on identifying 'a wide category of common intra-group services fees which command a very limited profit mark-up on costs',[16] a noble goal to be sure since intra-group services are regularly front and centre in transfer pricing quarrels. Parts A, B and C of the suggested OECD draft did not diverge from Chapter VII of the OECD TP Guidelines (July 2010), that is, they abided by the arm's length principle.

Then, things got a little clearer for the proponent of global formulary apportionment or more blurry for the arm's length principle advocates in Part D of the draft (*Low value-adding intra-group services*). Part D proposes a 'purported' elective method to determine the arm's length charge of 'low value-adding intra-group services'. Gems like this one found in paragraph 7.46 can be read in Part D of the draft:

> [...] the guidance in this section is not applicable to services that would ordinarily qualify as low value-adding intra-group services where such services are rendered to unrelated customers of the members of the

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7 OECD public discussion draft: *BEPS Action 10: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services,* (3 Nov. 2014–14 Jan. 2015), 3 Nov. 2014; online: http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-low-value-adding-intra-group-services.htm.

8 OECD public discussion draft: *BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains,* (16 Dec. 2014–6 Feb. 2015), 16 Dec. 2014; online: http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-profit-splits-global-value-chains.htm.

9 OECD public discussion draft: *BEPS Action 4: Limit base erosion via interest payments and other financial payments,* (18 Dec. 2014–6 Feb. 2015), 18 Dec. 2014; online: http://www.oecd.org/ ctp/aggressive/discussion-draft-action-4-interest-deductions.htm.

10 OECD public discussion draft: *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures),* (1 Dec. 2014–6 Feb. 2015), 19 Dec. 2014; online: http://www.oecd.org/ctp/transfer-pricing/discussion-draft-actions-8-9-10-chapter-1-tp-guidelines-risk-recharacterisation-special-measures.htm.

11 OECD public discussion draft: *BEPS Action 7: Preventing the Artificial Avoidance of PE Status,* (31 Oct. 2014–9 Jan. 2015), 31 Oct. 2014; online: http://www.oecd.org/ctp/treaties/discussion-draft-action-7-prevent-artificial-avoidance-pe-status.htm.

12 OECD public discussion draft: *Follow Up Work on BEPS Action 6: Preventing Treaty Abuse,* (21 Nov. 2014–9 Jan. 2015); online: http://www.oecd.org/tax/treaties/discussion-draft-action-6-follow-up-prevent-treaty-abuse.htm.

13 OECD public discussion draft: *BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions,* (16 Dec. 2014–6 Feb. 2015), 16 Dec. 2014; online: http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-cross-border-commodity-transactions.htm.

14 OECD public discussion draft: *BEPS Action 14: Make dispute resolution mechanisms more effective,* (18 Dec. 2014–16 Jan. 2015), 18 Dec. 2014; online: http://www.oecd.org/ctp/dispute/discussion-draft-action-14-make-dispute-resolution-mechanisms-more-effective.htm.

15 The rest of this paper partially draws from our submissions to the OECD on some of these public discussion drafts.

16 See on p. 3.

MNE group. In such cases it can be expected that reliable internal comparables exist and can be used for determining the arm's length price for the intra-group services.

In layman terms, the OECD guidance makes an unexpected delineation. It suggests an artificial distinction between intra-group services where internal comparables are available and other services where they may be no internal comparable available. From a practitioner perspective, this is somewhat disturbing on many levels. First, the proper use of the arm's length principle, which starts from the comparability analysis and goes on with the selection and application of a transfer pricing method, has never been restricted to the availability of internal comparables. Second, the guidance seems to imply that internal comparables should be preferred to external comparables.

This is ground-breaking policy. Could such a proposal ultimately introduce in the OECD TP Guidelines the seeds of formulaic approaches (i.e., formulary apportionment) to the determination of a transfer price in every case where comparables are allegedly 'unavailable' or comparability is deemed to be 'poor'? The answer is a resounding 'yes' as will be seen below in our discussion on profit split methods.

But limiting the scope of our discussion to low value-adding intra-group services for the moment, paragraphs 7.47–7.50 of the OECD draft move right into the formulary apportionment universe by putting forward in paragraph 7.48 a wide-ranging definition of 'low value-adding intra-group services'. To that effect, human capital leaders, accountants, legal and IT personnel in small, medium and large organizations alike might be slightly annoyed since all of their activities are deemed to meet the definition of low value-adding services for transfer pricing purposes.

Strangely enough, the relevance of the comparability analysis as per Chapter I of the OECD TP Guidelines is nowhere to be directly found in that definition. Paragraph 7.57 of the OECD draft confirms that the determination of a low value-adding intra-group service has nothing to do with the arm's length principle anymore where it can be read that 'the mark-up selected by the taxpayer [for its low value-adding intra-group services] should be no less than 2% of the relevant cost and should be no greater than 5% of the relevant cost'.

As a point of comparison, §1.482-9(b)(3)(ii) of the Code of Federal Regulations in the United States defines what is not a 'low margin covered service'. Aware of the relevance of the arm's length principle for that determination, §1.482-9(a) and §1.482-9(b)(5) explicitly mention the necessity of the functional analysis in order to make the determination that a service is in fact a 'low value-adding intra-group service' prior to benchmarking its value for transfer pricing purposes. In short, the use of a formulaic approach should follow from the proper application of the arm's length principle in the United States. §1.482-9(b)(3)(ii) indicates that these intra-group services are entitled to a 'median comparable mark-up on total services costs [that] is less than or equal to seven percent'.

In Europe, the benchmarking of profit mark-up for low value-adding intra-group services is also proposed although the guidance on the matter states that 'an exhaustive definition of the services to which this paper applies is neither possible nor desirable. This is because of the range of services provided intra-group and the differing commercial impact that services can have within the context of a particular commercial activity'.[17] Simply stated, a thorough comparability analysis is indeed required both in the USA and Europe prior to any form of benchmarking, not so much so in the OECD guidance.[18]

The devil's advocate may nonetheless suggest that the proposal of the OECD should solely be considered as a sensible application of the safe harbour principles suggested in Part E of Chapter IV of the OECD TP Guidelines (as it was amended on 16 May 2013).[19] After all, as indicated in paragraph 4.110, 'safe harbours involve a trade-off between strict compliance with the arm's length principle and administrability. They are not tailored to fit exactly the varying facts and circumstances of individual taxpayers and transactions'. However, support for that comforting assertion quickly fizzles as will be seen below.

3 The arm's length principle and the comparability analysis (part I)

Even though a public discussion draft does not make a trend, two or more may indeed mark the start of the said trend. In the same vein, public discussion draft *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)* released on 19 December 2014 can hardly be perceived as another favour to safe harbour advocates. This document updates the 'guidance for applying the arm's length principle', that is, Part D of the OECD TP Guidelines. It goes directly to the heart of the comparability analysis for the application of the arm's length principle.

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17 European Commission, *JTPF Report: Guidelines on Low Value Adding Intra-Group Services*, Meeting of 4 Feb. 2010, Brussels, para. 8 (see para. 61–65 for benchmarking).

18 To this day, benchmarking is absent from the Canadian transfer pricing landscape. It is nowhere to be found in s. 247 of the Canadian *Income Tax Act* or in Information Circular *IC 87-2R International Transfer Pricing*.

19 OECD (2013), *Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines*.

Paragraph 2 of the draft sets the tone right away. It introduces in the analysis of the contractual terms of a specific controlled transaction the examination of the interaction of the controlled transaction with the 'rest of the value chain'. This is formulary apportionment in its simplest form of expression, nothing less.

Theoretically, on the one hand, it should be noted that parties dealing at arm's length would not consider the arm's length dealings of their other clients or other suppliers to establish the terms and conditions of their own arm's length dealings unless unusual conditions were present. On the other hand, in the design of the specific contractual terms of a specific commercial transactions, parties dealing at arm's length would not consider either their own arm's length dealings with other clients or other suppliers unless the typical information asymmetry, which is part of the principal-agent problem, was disrupted. That is, the rest of their own arm's length value chain would not be considered. In other words, the introduction of the notion of the 'rest of the value chain' in comparability analysis is an astonishing drift of the OECD toward global formulary apportionment.

From a practical standpoint, the examination of the rest of the value chain for transfer pricing purposes is also highly provocative. For tax administrations, it would necessitate the access to qualitative information that will not be made available neither through the Master file nor the country-by-country (CbC) reporting template as presented in Annexes I and III of the *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*.[20] In light of the new guidance contained in paragraph 2 of the OECD draft *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)*, 'establishing the conduct of the parties' involved in a controlled transaction would likely require access to the local files made available in other tax jurisdictions. However, these local files were not meant to be accessible to every tax administration that may audit a given controlled transaction, at least according to the wording in Part E (implementation) of the *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*.

This major philosophical shift of the OECD on the relevance of the 'rest of the value chain' in the comparability analysis is exacerbated by option no. 4 (minimal functional entity) in the section on 'potential special measures' of *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)*. 'Option 4' indicates that cases where an entity lacks the 'appropriate' FRA mix (functions, risks, assets) the profits of such an entity may be reallocated. What is markedly troubling is the fact that this alleged 'arm's length determination' would not necessarily be based on the customary comparability analysis required for the application of the arm's length principle. In other words, the arm's length principle could purportedly be applied without the need for the comparability analysis. The OECD draft suggests that the profit reallocation may be centred and defensible by insufficient headcount, revenues arising mainly from non-arm's length streams, or insufficient assets in the alleged 'rogue' corporate entity. That is to say that the reallocation of profits would be based on synthetic rules that are eerily similar to some of those included in Controlled Foreign Company (CFC) regimes already used all around the world, regimes which find their conceptual foundation in pure formulaic designs, that is, practical applications of formulary apportionment.

4 The arm's length principle and the comparability analysis (part II)

Another recent public discussion draft released by the OECD advocates a similar philosophical schism from the arm's length principle and the relevance of the comparability analysis for transfer pricing purposes. Public discussion draft *BEPS Action 4: Limit base erosion via interest payments and other financial payments* clearly indicates that the comparability analysis is not required anymore for legitimate commercial intercompany loans and other financial transactions. Candidly, the OECD explains its motivations in this draft by the fact that the formulaic domestic rules introduced in various countries around the world have had 'limited success'[21] in curbing the alleged 'profit-shifting techniques available in international tax planning' related to financial transactions.[22]

In the dense ninety-three pages comprised in this draft, no reference whatsoever is made to the comparability analysis or the functional analysis, which is crucial to the application of the arm's length principle. The main options of 'group-wide test rules' (section VIII of the draft) and 'fixed ratio rules' (section IX) for the purposes of transfer pricing and international taxation, as they would apply to various financial transactions, are unmistakably based once more on purely formulaic designs very similar to what is found in domestic legislation all around the

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[20] OECD (2014), *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing; online: *http://dx.doi.org/ 10.1787/9789264219236-en*.

[21] *Supra,* paras 4–5.

[22] *Supra,* para. 1.

world including in the Canadian *Income tax Act*.[23] In other words, the reallocation of profits by tax administrations is based on arbitrary rules that bear no relationship of any kind with the arm's length principle.

In the context of the BEPS initiative, to portray the relevance of this issue and sell the proposed non-arm's length remedies to its consequences as being the logical result of 'academic studies'[24] is somewhat curious. First, this OECD draft on BEPS action no. 4 should be read in narrow juxtaposition with two other OECD classic documents titled *Double Taxation Conventions and the Use of Base Companies* and *Double Taxation Conventions and the Use of Conduit Companies*, both released on 27 November 1986 (this is not typo) which describes the same exact phenomena.[25] There is nothing new here. The phenomena have been known for at least the last thirty years. As such, it is the timing of the non-arm's length remedies applied on a 'group-wide basis' that is rendered even more conspicuous.

Second, for some reason the OECD draft omits to point out that these purported shortcomings of the domestic legislations in relation with financial transactions are limited to the 'international tax planning' of corporate entities while there is in fact evidence that they have been largely successful in lessening such type of planning by 'flesh and blood' individuals.[26] This visibly indicates that tax incidence theory may have to be taken seriously at some point as far as corporate taxation is concerned. Like we have written elsewhere, modern taxation theory teaches us through the wise words of Edwin R.A. Seligman[27] that 'the settlement of the tax burden [falls] on the ultimate taxpayer'.[28]

The blatant disregard for the core foundations of the arm's length principle in this specific OECD draft must in the end be appreciated through the general philosophical drift toward global formulary apportionment as abundantly illustrated in this short article. At this point of our examination, we dare to state that we have definitively departed safe harbour territory when the above-mentioned public discussion drafts are considered together. But there is even more to ponder.

5 The global value chain for transfer pricing purposes

On the one hand, we previously saw that the comparability analysis of a specific controlled transaction may soon mean including the 'rest of the value chain'.[29] On the other hand, we have seen many instances where the guidance put forward by the OECD simply ignores the comparability analysis for the determination of an 'arm's length price'. This begs the question: how do we define and what is the relevance of the 'global value chain' for transfer pricing and international taxation purposes?

Public discussion draft on the *Use of Profit Splits in the Context of Global Value Chains,* released on 16 December 2014, takes an interesting crack at this key question for transfer pricing purposes. This OECD draft also crystallizes the philosophical shift toward formulary-like approaches for international transfer pricing. The draft on the *Use of Profit Splits in the Context of Global Value Chains* stems from the work already done by the OECD on the digital economy,[30] the transfer pricing aspects of intangibles[31] and the global value chain concept.[32]

In the introductory remarks, it is stated that the 'Working Party No. 6 on the Taxation of Multinational Enterprises has considered a number of scenarios where it may be more difficult to apply one-sided transfer pricing methods to determine transfer pricing outcomes that are in line with value creation, and where the application of a transactional profit split method may be appropriate.' The remarks also indicate that the 'questions [suggested in the draft] are intended to elicit responses which will then be taken into account by Working Party No. 6 in considering revisions to the guidance on the use of the transactional profit split method in Chapter II of the Transfer Pricing Guidelines'. With this objective in mind, nine specific scenarios are therefore laid out in each of which the OECD suggests that the profit split method may be applicable. Some scenarios do indeed elicit some stern concerns for the future well-being of the arm's length principle in international transfer pricing.

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23 For example, s. 18 in the case of thin capitalization rules.

24 *Supra,* para. 10.

25 Both documents are available in the appendices of *OECD Model Tax Convention on Income and Capital. Full version,* Vol. II, reports R(5) and R(6).

26 In Canada, see for example *Fundy Settlement v. Canada, 2012 SCC 14*.

27 Historically, it is notable that Mr Seligman was a member of the group of economists appointed by the League of Nations to study the key principles of taxation of cross border activities (See *Report on Double Taxation submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp*, League of Nations Document No. E.F.S.73.F.19. 1923.

28 Edwin R.A. Seligman 1921, *The Shifting and Incidence of Taxation*, Columbia University Press, New York, p. 1, available online https://archive.org/details/shiftingandincid00seli.

29 *Supra,* para. 2, *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures).*

30 OECD (2014), *Addressing the Tax Challenges of the Digital Economy,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

31 *Supra, Guidance on Transfer Pricing Aspects of Intangibles*.

32 OECD (2013), *Interconnected Economies: Benefiting from Global Value Chains*, OECD Publishing.

With respect to the 'fragmentation of functions', paragraph 26 of the draft on the *Use of Profit Splits in the Context of Global Value Chains* posits that this is 'common in an integrated value chain'. That broad statement is somewhat imprecise. As put forward in paragraph 21 of the public discussion draft *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures),* a more accurate wording would be to suggest that fragmentation of functions does indeed represent a specific situation where 'an MNE group has the capability to fragment even highly integrated functions across several group companies to achieve efficiencies and specialisation, secure in the knowledge that the fragmented activities are under common control for the long term and are co-ordinated by group management functions'.

But even when they are taken together, some of the wording choices remain unfortunate. These OECD statements imply that the fragmentation of functions is accomplished through the compartmentalization of the global value chain, that is, each function would somehow be extracted of the whole; in other words, artificially rendered independent although still part of the global value chain. These are unwelcomed over-simplifications that also demonstrate a misunderstanding of the matter at hand.

'Fragmentation of functions', as it is used by the OECD, does not pertain to the analysis of the actual global value chain. In the OECD's own words, 'fragmentation of functions' relates instead to 'narrow activity conducted by the controlled enterprise'[33] and functions such as 'logistics, warehousing, marketing, and sales functions [which] may require considerable co-ordination in order that the separate activities interact effectively'.[34] These are the 'support activities' as labelled by Michael Porter.[35] Plainly stated, these are not the functions or the activities typically referred to when comes the time to perform the analysis of the global value chain of an MNE group.

For the MNE group, fragmentation of function, if anything, is usually about increasing the efficiency of the 'costs centres', not of the 'profit drivers' in the MNE group; the latter being the main component of the global value chain as accurately highlighted in Chapter I of *Interconnected Economies: Benefiting from Global Value Chains* released by the OECD on 28 May 2013.[36]

It follows from these observations that paragraph 27 of the draft on the *Use of Profit Splits in the Context of Global Value Chains* is without any factual basis with respect to the new guidance suggested in Part D of the draft on *Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services* as seen above. If the determination of the arm's length price of any cost centres, that is, of a low value-adding intra-group service, may allegedly be achieved through an optional simplified approach, how could a profit split method ever be considered? The answer is simple: there are serious conceptual misunderstandings and intellectual struggles at work in these disconnected OECD public discussion drafts. We are to be sure on the fence between the arm's length principle and global formulary apportionment.

The draft on the *Use of Profit Splits in the Context of Global Value Chains* goes even further to endorse our contentious observations. 'Scenario 6' suggests the design of 'profit split methods' exclusively based on the headcounts in Company A and Company B, which would drive the allocation of the 'total system profit' between both companies. This is the expression of an overly simplified contribution analysis to put it mildly. Although the OECD claims that the draft and these scenarios have been premeditated to 'elicit responses' which should keep in mind that a thorough functional analysis remains 'relevant', this is going way too far.

Such a scenario is in fact absolutely incompatible with Chapter I of the OECD TP Guidelines, even as updated by the proposals included in public discussion draft *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)*. From a tax administration perspective, this scenario is however fully coherent with the implementation of what we would label squeaky clean global formulary apportionment methods where headcount would act as the single apportioning factor. But then why bother putting forward guidance on the relevance of the 'global value chain' for transfer pricing purposes in the first place? Conceptual misunderstandings and intellectual struggles for sure.

6 Is the arm's length principle on its death bed?

Taken as a whole, our observations in this paper bring to the table the dreaded question: is the arm's length principle on its death bed? Will BEPS ultimately lead the arm's length principle to hara-kiri? If the public discussion draft on the *Use of Profit Splits in the Context of Global Value Chains* for one is to be given any amount of credibility, global formulary apportionment is clearly

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[33] Paragraph 26 of *Use of Profit Splits in the Context of Global Value Chains*.

[34] Paragraph 21 of *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)*.

[35] See Michael E. Porter, (1985), *Competitive Advantage: Creating and Sustaining Superior Performance*, Free Presse, New York.

[36] *Supra Interconnected Economies: Benefiting from Global Value Chains*.

gaining ground in some circles. But making ours for a moment the wise words of Friedrich von Hayek, this may well be the 'fatal conceit' as far as transfer pricing and international taxation are concerned.[37]

One of the entrenched beliefs behind two-sided and multi-sided transfer pricing methods is that they shall enable the resolution of the ills and wrongs associated with one-sided methods without creating new weaknesses and issues in international taxation. Formulary-like transfer pricing alternatives do indeed enable the OECD 'to boldly go where no man has gone before'[38] in international taxation.

But tax administrations may soon be in for some unsettling surprises out there. As formulary-like transfer pricing alternatives are forcibly pushed into the international tax regime, more and more 'guidance' will be (and is actually) developed. This guidance, notwithstanding the wishful thinking and writings of the OECD, will keep being implemented unilaterally by tax administrations all around the world. There is little doubt that a spectacular increase in the number of tax disputes and tax litigations will ensue.

Formulary-like transfer pricing alternatives, as they are actually put forward by numerous independent OECD public discussion drafts, basically eliminates the relevance of a thorough comparability analysis from which follows the proper application of a transfer pricing method, be it an arm's length method or an alternative method. These formulary-like transfer pricing alternatives basically exclude vital and essential reference points, both qualitative and quantitative, that are critical to an evidence-based and principle approach to any negotiated resolution of double taxation. We may soon start to reap the unpleasant fruits of what is being awkwardly sown.

Formulary-like transfer pricing alternatives may have their place in international transfer pricing but certainly not in the disconnected way that they are actually stuffed into public discussion drafts. All this to say that although the arm's length principle may not be ready just yet for the graveyard, a future death by a thousand cuts may soon be pronounced as the OECD keeps issuing 'public consultation drafts' that undermine its core philosophies and foundations.

International transfer pricing is now at the gates of a hybrid global formulary apportionment system if not by name, surely by trade. We may not like what lies behind those gates…

Notes

[37] F.A. Hayek (1988), *The Fatal Conceit. The Errors of Socialism*, The University of Chicago Press.

[38] From the *Star Trek* opening theme.

[A] Aim of the Journal

This established international tax journal offers detailed coverage of direct tax, indirect tax, and social security from both legal and economic angles, and provides 12 issues a year of practical, up-to-date, high-level international tax information. Coverage includes all aspects of transnational tax issues. The journal includes authoritative, reliable content, written for tax attorneys, practitioners (litigation and transactional) in other areas where international tax issues are a concern, and academics.

[B] Contact Details

Manuscripts should be submitted to the General Editor, Fred de Hosson.
E-mail address: Fred.deHosson@bakermckenzie.com

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