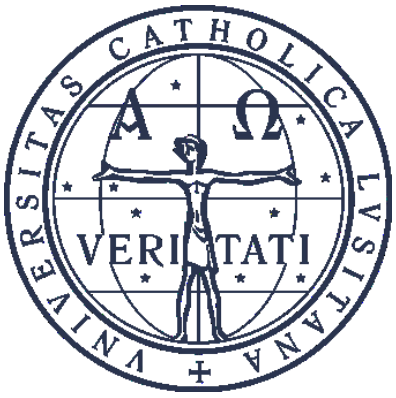

UNIVERSIDADE CATÓLICA PORTUGUESA

International Transfer Pricing

Rethinking the Arm's Length Principle

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Dissertation submitted for the degree of Master in Tax Law, under the orientation of Professor Mónica Duque

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Abstract

Considering the current economic reality, one must realize the dominant market position assumed by multinational corporations through the establishment of highly integrated operations between their subsidiaries. Such context is completely contrary to the one where separated and independent enterprises act.

In light of a new economic and business paradigm, the arm's length principle starts to be questioned as the most appropriate method to cope with transfer pricing issues and the negative impacts that may arise from such transactions. At the same time, other approaches are starting to be suggested by academics in order to combat the flaws of the actual system, namely a unitary regime.

It is possible to foresee a long discussion about what is the right approach to be adopted, as both standards reveal strengths and weaknesses.

Keywords: arm's length principle; common consolidated corporate tax base; formulary apportionment; separate approach; transfer pricing; unitary approach.

Resumo

Atendendo à atual realidade económica, torna-se importante compreender a posição dominante que as empresas multinacionais ocupam no mercado, através da realização de operações altamente integradas estabelecidas entre as suas subsidiárias. Este contexto é completamente oposto àquele onde entidades separadas e independentes atuam.

À luz de um novo paradigma económico e negocial, o princípio da plena concorrência tem começado a ser questionado enquanto método mais apropriado para lidar com problemas em matéria de preços de transferência e com possíveis impactos negativos que daí possam advir. Paralelamente, outras metodologias têm sido sugeridas de modo a combater as falhas do atual sistema, nomeadamente o sistema unitário.

Tendo em conta que ambos os regimes apresentam várias vantagens e desvantagens, é possível prever um longo debate sobre qual será o método mais adequado a adotar.

Palavras-chave: princípio da plena concorrência; base fiscal societária comum e consolidada; fórmula de repartição; abordagem separada; preços de transferência; abordagem unitária.

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To my parents, for the unconditional love and for making all this possible.

To my grandparents, for teaching me everything that books cannot; for receiving me at their home and love me in a way that became almost impossible to return.

To Cláudia, my love, for being the strongest and most faithful pillar in my life.

Finally, to my friends for multiply the happiness and divide the sadness; especially to Juliana, Sérgio, Sebastião and Sofia for the memories and loyal friendship.

“Taxes, after all, are dues that we pay for the privileges of membership in an organized society.”
Franklin D. Roosevelt

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List of Abbreviations

ALP Arm's length Principle
ALS Arm's Length Standard
BEPS Base Erosion and Profit Shifting
CCCTB Common Consolidated Corporate Tax Base
CUP Comparable Uncontrolled Price Method
EC European Commission
EU European Union
FA Formulary Apportionment
G20 Group of twenty
MNE Multinational Enterprise
OECD Organization for Economic Co-operation and Development
OECD MTC OECD Model Tax Convention
OECD TPG OECD Transfer Pricing Guidelines
PE Permanent Establishment
PSM Profit Split Method
R&D Research and Development
SME Small and Medium Enterprises
TFUE Treaty on the Functioning of the European Union
TNC Transnational Corporation
TNMM Transactional Net Margin Method
UN United Nations
UN MDTC United Nations Model Double Tax Convention

Chapter I – Introduction and Context

1.1. Introduction

If the phenomenon of economy development and globalization is from one side welcomed by international community, the same cannot be said regarding tax avoidance and tax evasion[1], as two of the world's tax most critical issues over the past few years.

Multinational companies appear as the dominant actor of the current international business landscape, settling a strong position on a major part of global transactions. It can be said that the appearance of MNEs is in the genesis of transfer prices, with the constitution of new and different business organization models allowing for a geographical and economic expansion beyond the national boundaries, demonstrating the "octopus phenomenon" of MNEs. The existence of complex corporate structures becomes a predominance, being most of the transactions performed by a highly integrated network of subsidiaries or branches which act under a common direction and interest[2].

The fact that the main goal of MNEs is profit maximization offers no resistance, but a full understanding of the reasons behind the multinational internal transactions might be revealed to be an inglorious task, as well as a "deception game" for tax administrations and legislators. The possibility of tax avoidance through the exploit of legal tax loopholes and lack of coordination amongst countries assures the unfairness of corporate profits taxation[3], which later results in the frustration of SMEs and individual taxpayers[4].

The OECD seems to be aware of this problem that strikes the fiscal revenue of most States and jeopardizes their commitment to prosecute their public function regarding security, infrastructures, education and other basic collective needs. The 2015 final BEPS report, composed by fifteen actions can be seen as a reaction to tax avoidance, making part of the creation of a new international tax framework, able to implement and most of all apply the idea that profits are taxed where value is created and economic activity takes place.

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[1] The idea of MNEs "refrain from tax avoidance practices and pay their fair share" was stated by the Dutch Finance Minister and European President Jeroen Dijsselbloem at an EU Finance Ministers meeting in Brussels, Belgium, 2016. Available at: http://www.reuters.com/article/us-eu-taxavoidance/times-are-changing-pay-your-taxes-euro-zone-chief-tells-corporations-idUSKCN11G0AB?il=0

[2] UN (2013), paragraph 1.1.3- refers that a significant volume of global trade these days consists of international transfer of goods and services, capital and intangibles within the MNE group.

[3] As pointed by EU Commission Vice-President Jyrki Katainen. Available at: http://www.reuters.com/article/us-eu-taxavoidance/times-are-changing-pay-your-taxes-euro-zone-chief-tells-corporations-idUSKCN11G0AB

[4] The same illustrious Politic said in 2016: "What is clear is that with every new case of unfair tax practice on abuse, public frustration grows". Available: http://www.reuters.com/article/us-eu-taxavoidance/times-are-changing-pay-your-taxes-euro-zone-chief-tells-corporations-idUSKCN11G0AB

1.2. Research developed: motivation and method

Research Motivation

During my master in tax law at Católica University of Porto, I had the opportunity to attend the course of Tax Planning, where I came across the theme of Transfer Pricing and their role in the present international tax stage and its inward relationship with MNEs economic policies. As one of the most prominent challenges of our days in a constantly changing environment, the fight against aggressive tax planning became global, being transfer pricing under the spotlight of the international community, as well as the ALP as the best solution to determine transfer pricing.

Thus, my interest to understand to what extent is it possible to adopt a new international tax method and respective consequences of that.

The fact that this theme is regarded as unexplored, where no profound reflection has yet occurred, only contributed to increase our personal motivation.

Problem Overview

Multinational enterprises are spread all around the world, establishing a considerable number of (internal) transactions, some commercially motivated, others purely tax motived. This results in a difficult, if not impossible, mission of tax authorities to know which profits are to be taxed, to which entity should they be allocated, which country has the right to tax a certain profit, etc. Innumerous questions are left hanging, resulting in an increase loss of tax revenue. The international standard accepted is the Arm's Length Principle, as countries last hope to fight against transfer pricing, although voices started to argument some deficiencies of this method and pointed towards different paths. It is precisely this mismatch of the ALP with the modern business models designed by MNEs and possible alternatives, that I will describe in this thesis.

Research Question

This master thesis will be focused on the following question:

"Is the Arm's Length Principle the most efficient method to determine transfer prices and to solve the problems related to the allocation of profits amongst different tax jurisdictions? What are the alternatives, and will they perform better than the current method?"

Research Methodology

This thesis was based on an intensive research of articles and opinions from several prestigious authors about transfer pricing, the ALP and its alternatives. We put our best effort to analyze the discussed method – advantages and disadvantages -, to present other alternatives and expose the viability of each one of them.

As is our intention to address the level of principles rather than the plan of implementation, the research was focused on foreign bibliography.

We assume entire responsibility for any scientific mistake or grammatical error that this thesis may contain.

1.3. Some definitions

To have a clear and sober notion of what we pretend to analyze with this thesis, we believe to be essential to briefly explain some of the terms that will be used throughout the work.

What is Base Erosion?

Base erosion concerns to a tax planning strategy that exploits loopholes and mismatches between different tax rules, in order to make profits "disappear" for tax purposes, therefore decreasing the tax base of a certain entity and the amount of tax payable in a specific jurisdiction.

What is Profit Shifting?

As the name may suggest, profit shifting corresponds to a movement of profits from jurisdictions where the activities generating those profits occurred to another jurisdiction where those profits will be subject to no or low-tax rates[5]. This represents an aggressive tax planning strategy, often used by MNEs to avoid their fair share of domestic tax.

What is Transfer Pricing?

Transfer pricing corresponds to the price charged by one company to another company within the same organization for transfer or sharing goods, services or other resources (intra-firm transactions). We can establish a distinctive line "with a market price, which is the price set in the marketplace for transfers (…) between unrelated persons."[6] The prices here practiced are not based on the same conditions as the ones practiced between independent parties acting under 'normal market forces', the so-called "arm's length prices".

What is a Related Entity?

To determine the existence of "related entities" we must analyze the element of control. Usually, the different parts of the same organization are "owned or controlled, directly or indirectly, by the same interests."[7] The level of control present in the relationship can be verified by the power to establish transfer prices, different from market prices.

"The degree of control (…) varies from jurisdiction to jurisdiction but generally looks for an effective majority control."[8]

[5] There is also the possibility of a profit deflection from a low tax country to a high tax country, if a "(…) member of their affiliated group has losses in that country or if they are able to exploit some loophole (…)" in that high tax jurisdiction, in ARNOLD & MCINTYRE (2002), p.55.
[6] *Ibid.* p.55.
[7] *Ibid.* p.55.
[8] NEIGHBOUR & OWENS (2002), p.951.

1.4. Transfer pricing contextualization: a change in the international landscape

Transfer pricing has become a fundamental tax issue over the last years, both for taxpayers and tax authorities, therefore trying to establish an economic and political path on this subject can be revealed as an extremely challenging task.

"[I]n step with the economy globalization, worldwide intra-group trade has grown exponentially."[9] Considered this idea of globalization as an "ever-increasing transnational"[10] phenomenon and the fall of boundaries to international trade, we must face the world as a global market featured by developments in information technology and communications, in which MNEs business activities and economic transactions assume special prominence[11]. Emerging from this economic context MNEs appear has an "an integrated hierarchical business organization [which] is superior in efficiency terms when compared with the interaction of independent firms in the open market"[12], allowing them to practice an economy of scale and to set the prices internally (different from unrelated companies). Transactions on a multinational corporate level are highly driven by common interests, different in all aspects from market forces existing between independent entities. Facing such unequal reality, it becomes urgent to determine the transfer price, i.e. the right price.

Transfer Pricing, as a pricing policy, is the primary method used on (and through) international tax law to allocate profits among different jurisdictions according to a "minimum tax cost" criteria; naturally, the countries' tax base will end up being molded in the same way.

As already referred, MNEs operate on a global scale which demands a high coordinated procedure. Hence, a challenge arises for them concerning the decentralization of the decision-making process between the entire company web, considered all the subsidiaries and branches with distinct locations – here, it is possible to argue the transfer pricing practice as a strategy to face the complexity of some decisions that may require a delegation of responsibilities within the corporation.

Considered the business coordination element, transfer pricing can also be deployed for tax purposes[13], as an aggressive tax planning tool. Profits are, therefore, shift to lower tax jurisdictions with the objective of decrease the MNE overall tax burden and avoid heavier tax liabilities that in normal conditions the corporation would be subject to.

At this point, we are dealing with a harmful tax planning mechanism, that compromises the wealth of states national tax system, preventing them from receiving their "fair

[9] OECD (2015a), p.27.
[10] RECTENWALD (2012), p.428.
[11] "(…) over 60% of world trade takes place within MNEs and so potentially gives rise to transfer pricing issues." in NEIGHBOUR & OWENS (2002), p.952.
[12] SCHÖN (2011), p.5.
[13] AVI-YONAH & BENSHALOM (2011), p.373.

share"[14] of corporate tax revenue. Such tax motivated transactions often suffer an adjustment[15], granting a (closer) correct allocation of taxable profits.

Against this background, corporate taxation has become a major concern for tax authorities all over the world[16], not just for OECD countries but also for emerging economies such as BRICS due to the MNEs international widespread settled net – although their operations are internationally dispersed, they are centrally coordinated. The importance of transfer pricing for tax and economic purposes is undoubtedly viewed by countries as common ground.

The discipline of transfer pricing has its foundations on two major principles: under a "separate entity approach" each company integrated in a TNC will be taxed and have its profits computed as if it operates individually, based on separate accounting[17]; in accordance with the ALP, prices charged between related companies must correspond to the prices that would have been practice amongst unrelated entities. Weighting this principle relation, RECTENWALD points that "[d]epending upon arms-length transfer pricing adjustments is a dysfunctional solution to a problem that is needlessly perpetuated by the insistence on separate entity treatment and the significance of transfer prices."[18]

Bearing in mind that most of cross-border transactions are conducted by MNEs, it is relevant to mention that the various purposes for companies to start using transfer pricing is "to help identify which parts of the enterprise are not performing well, to escape double taxation when repatriating profits and ultimately to reduce tax."[19]

As aforementioned, it offers no resistance that the members of the same corporate group often manipulate the prices charged within the group to achieve an expected cost minimization, albeit, "[t]he mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length."[20] There are reasons to believe that economic and market alliances aiming convergent goals are frequently designed between companies.

[14] ASAKAWA, p.7.
[15] OECD (2015a), p.27.
[16] KOFLER (2013), p.650.
[17] "(…) the OECD member countries have decided, on balance, to adopt the "functionally separate entity" approach as the "authorised OECD approach (…)"; "(…) the authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions (…) in OECD (2006), p.12.
[18] RECTENWALD (2012), p.441-442.
[19] HASKIC (2009), p.2.
[20] OECD (2010a), para.1.11.

1.5. BEPS and the OECD role: general ideas

At the Los Cabos meeting, on June 2012, the G20[21] [22] Leaders reiterated "[their] commitment to strengthen transparency and comprehensive exchange of information", just as "the need to prevent base erosion and profit shifting", and stated that they would "follow with attention the ongoing work of the OECD in this area."[23]

Discussion around base erosion and profit shifting has reached the level of political priority of OECD[24] [25] and non-OECD countries' agenda. A tangible proof of this is the (lengthy) Report released by the OECD on Addressing Base Erosion and Profit Shifting, published on February 2013, - stating the countries' concern regarding the serious risk to tax revenues and tax fairness[26] resultant from MNE aggressive tax planning - and the Action Plan on Base Erosion and Profit Shifting[27], published on July 2013.

There is a need to recognize that beyond the current problem of tax compliance, and the obvious massive loss of tax revenue, base erosion and profit shifting also stand a major threat to tax sovereignty and to "the trust in the integrity of tax systems of all countries", producing "a negative impact on investment, services and competition, and thus on growth and employment globally."[28]

The Report confirms the difficulty "to reach solid conclusions about how much BEPS actually occurs", mentioning, however, "the circumstantial evidence that BEPS behaviors

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[21] The G20 policy is based on three main purposes: "policy coordination between its members in order to achieve global economic stability, sustainable growth; promoting financial regulations that reduce risks and prevent future financial crises; modernizing international financial architecture". Available at: http://en.g20russia.ru/docs/about/about_G20.html

[22] The G20 countries are: Argentina, Australia, Brazil, Canada, China, France, the European Union, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States of America.

[23] G20 Leaders Declaration at Los Cabos, Mexico, June 19, 2012, para.48, Available at: http://www.g20.utoronto.ca/2012/2012-0619-loscabos.pdf
Special note for the G8 Leaders Communiqué at the 2013 Lough Erne, stating that "On tax avoidance, we support the OECD's work to tackle base erosion and profit shifting." p.1, Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207771/Lough_Erne_2013_G8_Leaders_Communique.pdf

[24] The Organization for Economic Cooperation and Development has the goal to promote "policies that will improve the economic and social well-being of people around the world". Available at: http://www.oecd.org/about/

[25] The current members of the OECD are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

[26] ERNST & YOUNG (2013). Available at: http://www.ey.com/gl/en/services/tax/international-tax/alert--oecd-releases-report-on-base-erosion-and-profit-shifting

[27] The G20 Finance Ministers expressed, at the 2013 meeting in Moscow, that they "fully endorse the ambitious and comprehensive Action Plan submitted at the request of the G-20 by the OECD aimed at addressing base erosion and profit shifting.", p.5.
Available at: http://www.g20.utoronto.ca/2013/2013_Final_Communique_FM_July_ENG.pdf

[28] Declaration on Base Erosion and Profit Shifting at the Meeting of the OECD Council at Ministerial Level, OECD, Paris, May 2013, p.2. Available at: http://www.oecd.org/tax/C-MIN(2013)22-FINAL-ENG.pdf

are widespread."[29] The secrecy around transfer pricing and the lack of transparency to the public on media tax cases, such as Google, Amazon or Starbucks, is regarded as a most undesirable practice.

Although some may argue that the OECD Report did not have the impact that was expected, or that it did not offer effective solutions, its prominent role must be noted.
Being the initial response to the G20 mandate, the Report operates a comprehensive analysis of the structural causes and consequences of base erosion and profit shifting, and refuses any sort of unilateral action as a solution for the problem. Against this background, it proposes that "[a] holistic and comprehensive approach is necessary to address the issue."[30] This integrated approach[31] was, therefore, endeavored with the Action Plan on Base Erosion and Profit Shifting[32].

With regard to the matter of transfer pricing, upon which this thesis is based, the Action Plan dedicates four actions of a total of fifteen contemplated actions:

- Action 8: Assure that transfer pricing outcomes are in line with value creation: Intangibles
- Action 9: Assure that transfer pricing outcomes are in line with value creation: Risks and capital
- Action 10: Assure that transfer pricing outcomes are in line with value creation: Other high-risk transactions
- Action 13: Re-examine transfer pricing documentation

It should be furthermore noted the existence of a Report[33], which "contains revised guidance [that] responds to these issues and ensures that transfer pricing rules secure [tax fair] outcomes (…)"[34]. In addition of being a direction line, providing a helpful supporting instrument, it also "represents an agreement of the countries participating in the OECD/G20 BEPS Project."[35]

Taking a closer look at the chronological element, it is possible to observe that the Action Plan procedure was conducted in just two years – which is applaudable. This only reveals the urgency of such diploma, either for political, business or social reasons.
As a project of global dimensions, BEPS presents itself as the result of "all G20 and OECD countries [working] on an equal footing [and] developing countries [that] were engaged extensively from the outset, via a number of different consultation

[29] OECD (2013a), p.15.
[30] "No More Shifty Business", available at: https://www.taxjustice.net/cms/upload/pdf/OECD_Beps_130327_No_more_shifty_business.pdf, p.2.
[31] Pascal Saint-Amans, Director of the OECD Centre for Tax Policy and Administration, reaffirms the very importance of a global coordinated action by mention that the work on BEPS "(…) could not be done by OECD countries alone if it was going to work.", in SAINT-AMANS (2014), p.68-69.
[32] Enforces "fundamental changes (…) designed to prevent and counter base erosion and profit shifting", in OECD (2013b), p.13.
[33] To better explain and implement the 15 Actions, 13 Reports were published.
[34] OECD (2015a), p.28.
[35] *Ibid.* p.28.

mechanisms."[36] In fact, this can be considered the BEPS first great accomplishment: "For the first time all OECD and G20 countries have worked together on an equal footing to design common responses to international tax challenges [with an] unprecedented participation by developing countries in the development of commonly-agreed international tax standards"[37], which among other aspects, highlights a strong political will.

The work developed by OECD and G20 in the BEPS program demonstrates a high-level of commitment towards solutions of a group of identified widespread problems.

This, naturally, creates great expectations amongst the governments involved that BEPS is able to have a profound impact on company's corporate structure and their abusive practices[38] [39].

Under the international community watchful eye, BEPS takes on an additional political importance. The OECD countries have maintained a dominant position over the international tax arena for more than 50 years, and even though the supporting role of the G20, the BEPS project bears the OECD "stamp". Thus, this project may create some political pressure at the shoulders of the international organization, due to an almost imperative need to reach a "successful outcome (…) so that they can keep control over international tax policy"[40].

In the worst-case scenario, i.e. failure of the project, the leadership of OECD over international fiscal matters may come out weakened.

[36] OECD (2015b), p.4.
[37] OECD (2015c), p.5.
[38] "The interim report shows that the OECD and the G20 member states have achieved a lot of progress in the Base Erosion & Profit Shifting project (…) [fighting] against international tax avoidance.", published by the Government of the Netherlands.
Available at: https://www.government.nl/latest/news/2014/09/19/the-netherlands-welcomes-progress-in-the-fight-against-international-tax-avoidance
[39] "With 100 countries and jurisdictions [working together] to tackle base erosion and profit shifting, strong progress in addressing this global problem is underway.", in OECD (2017), p.31.
[40] BAKER (2013), p.1.

Chapter II – The Arm´s Length Principle

2.1. Background

Historically, the ALP has a long and interesting tradition that can be traced back to the beginning of the 20th century.

The League of Nations assembled, in 1928, a Fiscal Committee that entrusted with the development of principles for the allocation of tax jurisdiction. The task was executed by Mitchell B. Carroll, whom investigated three methodologies for the problem of business income allocation: the separate accounting method; empirical methods (later referred by Carroll as the fallback measure for separate accounting); and formulary apportionment[41].
The result was a draft made by the Committee in 1933 (which was followed by the 1935 draft), where it is possible to see the reference "dealing at arm's length"[42] as a promotion of the arm's length method over other methods.

During World War I, the need for transfer pricing legislations became a prominent necessity in countries such as U.S. and U.K. in order to prevent the shifting of profits in a time where taxes assumed a critical political importance.[43]
In 1935, the ALP was first implemented in U.S. tax regulations, stating that "[t]he standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[44] The function undertook by the article was the reallocation of income and deductions amongst controlled taxpayers in respect to intra-group transactions established between them.
By the time, the concern was to empower fiscal authorities to assure that income was taxed where it belongs, therefore standing against profit shifting strategies perpetrated through suspicious related transactions.

The consciousness over the importance of tax revenue to the performance of government obligations was already a reality[45]. Thus, we believe it is righteous to say that the moral tax compass was born around this time with a demonstration of deep concern regarding the preservation of corporate tax base against evasive tax planning practices.

In 1963, the ALP was adopted in art.9º of the OECD MTC, and later in 1980 the UN followed the same path – as it is possible to see in art.9º of UN MDTC between Developed and Developing Countries.

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[41] MARKHAM (2005), p.15.
[42] League of Nations (1935), art.3º.
[43] Ad Hoc Group of Experts on International Cooperation in Tax Matters (2010), p.5.
[44] Art. 45-1/b) "Determination of the taxable net income of a controlled taxpayer", of Regulations 86 related to the Income Tax under the Revenue Act of 1934, U.S. Treasury Department. Available at: http://constitution.org/tax/us-ic/regs/Regs_86_for_1934_act.pdf
[45] "A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment. (…) New business creates new tasks, entails further public expense [and therefore] (…) taxes upon business have great fiscal virtue as such.", in ADAMS (1917), p.187.

The feature that better suits ALP is clearly its global application, "as it forms the basis of an extensive network of bilateral income tax treaties between OECD member countries and between OECD member countries and non-OECD economies"[46] and it is present in most of country's domestic tax legislation.

2.2. OECD Transfer Pricing Guidelines: special note

An increase of MNEs and the frequency of related transactions since 1960's exposed the need for further guidance on transfer pricing, leading to a reaction by OECD that considered the real necessity to develop practical guidance for its members' tax authorities.

To a large extent, the 1968 U.S. rules on controlled transactions had a considerable influence in the discussions and development of the OECD Guidelines[47].

The OECD's Committee on Fiscal Affairs, in particular Working Party No.6, produced in 1979 the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which was not meant to create an extensive set of regulation, "but rather to set out the problems and the considerations to be taken into account and to describe which methods and practices were acceptable from a tax point of view in determining transfer prices."[48].

The OECD Guidelines are continuously reviewed and updated in order to deal and cope with the massive changes and challenges posed by technological developments and an overwhelming globalized economy.
In 1995, the Guidelines were updated to deal with the mentioned challenges and also to "bridge the differences which have arisen between the United States and other OECD countries"[49]; in 2010, another update was made to the Guidelines to consider the revision of the guidance on comparability and profit methods (chapter I-III of the Guidelines) and on business restructurings (chapter IX of the Guidelines).

As mentioned by WITTENDORFF, the OECD Guidelines have the aim to "create a uniform international legal approach to the application of the arm's length principle"[50] and, therefore, narrow the differences between different tax systems.

Despite the objectives undertaken by the OECD Guidelines, such implementation poses great difficulties due to the existent gap between developed and developing countries, that only appears to be increasing.

[46] RUITER (2012), p.1.
[47] WITTENDORFF (2010), p.14-15.
[48] Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting (2001), p.7.
[49] *Ibid.*, p.19.
[50] WITTENDORFF (2010), p.14.

2.3. A first incursion

"Dealing at arm's length" means that transactions established between related parties are to be considered as if the parties involved were independent, dealing under identical conditions and economic circumstances. This principle intends to assure an equal ground of treatment amongst TNCs (operating internally) and separate business entities (operating independently)[51], neutralizing the effects that may arise from such difference and, thus, ensuring that this does not result in position distortions created by undue tax advantages for MNEs[52].

We can, therefore, determine that the philosophy behind the ALP is "that each affiliated company within the group transacts with other members of the group in the same way that it would transact if the members were unrelated"[53] and thereby at market prices.
The ALP global acceptance, along with its recommendation and adoption[54] by OECD as the international transfer pricing standard, arises in response to this need of determine the right "market price" for intra-group transactions. However, such accurately determination may reveal genuine difficulties for tax authorities, as OECD seems to be aware.[55]

Being the uncontrolled transactions subject to the forces of a full competitive market and its strengths (setting the bar of what will be considered "arm's length"), one can obtain a "benchmark against which the controlled transactions can be evaluated."[56] Therefore, a transfer pricing review is made based on a comparability analysis that has its fundament both on art.9º of the OECD MTC[57] [58] and art.9º of the UN MDTC – the same method is also present in art.7º of the OECD MTC, as it is embedded in several treaties and countries' national legislations (although it does not mean that it is explained the same way in each country).

The principle, as established in art.9º/1 of the OECD MTC, determines that: "*Where (...) conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*"

[51] The same idea is provided in PICCIOTTO (2012), p.3.
[52] SCHOUERI (2015), p.695.
[53] AVI-YONAH (2009), p.3.
[54] the OECD has already showed a public support and acceptance of the ALP, as it is possible to see in OECD (2010a), para. 1.14-1.15.
[55] "Tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits.", in OECD (2010b), p.4.
[56] NEIGHBOUR & OWENS (2002), p.952.
[57] Setting "(…) forth the requirement for a comparison between conditions made or imposed between associated enterprises and those that would be made between independent enterprises.", in RUSSO & BOYKIN (2008), p.1.
[58] Constitutes the framework for bilateral treaties between OECD countries as well as to non-members.

Objectives such as fair allocation of the tax base in each jurisdiction and the avoidance of double taxation, demonstrate why this principle is embodied in a considerable number of legal documents and treaties[59].

The establishment of "an appropriate adjustment" in paragraph 2 of the same article materializes the aforementioned principle, while assures a minimization or elimination of economic double-taxation[60].

In this regard, transfer pricing adjustment is defined as a pure correction mechanism which recognizes for tax purposes the real transaction and assures a proper allocation of taxable profits amongst the related parties – an increase in the profits of one company will dictate a corresponding decrease in the profits of the affiliated member.

It is also important to note that the possibility of tax administrations to make adjustments based on tax treaties will always be limited by domestic tax law, i.e. the taxing rights of each country cannot be broadened by a tax treaty, "in accordance with the so-called golden rule of tax treaty law."[61]

Despite the (well-known) fact that transfer pricing practices are used for tax purposes, the concept of transfer pricing "(…) should not be [legally or economically] confused with the consideration of problems of tax fraud or tax avoidance (…)"[62]. Furthermore, and considered the existent corporate economic dynamic, it becomes fundamental to distinguish between tax motivated and business motivated transactions, as internal cross-border activity may be established without the purpose of profit manipulation, but instead due to valid economic reasons; based on this premise tax authorities should consider the existence of other purposes than tax avoidance[63] [64].

The possibility of a different solution in this matter would only lead to two undesirable outcomes: first, the disregard of commercial motivated decisions by fiscal authorities would eventually lead to a global decline of the business flow; second, if tax motivated transactions were recognized MNEs would be completely free to choose the jurisdiction where they would want their profits to be taxed[65].

The international siege appears to be closing on the ALP and it is precisely its core that is currently under strong attack by academics, stating SCHÖN that this standard "cannot be

[59] OECD (2010a), Preface, para.7.

[60] Although, Mutual Agreement Procedures (art.25º OECD MTC) can be used by tax administrations "(…) to resolve disputes regarding the application of double tax conventions [eliminating] double taxation that could arise from a transfer pricing adjustment.", in OECD (2010a), para.4.29.

[61] LANG (2001), p.80.

[62] OECD (2010a), p.31.

[63] "While it is evident that tax authorities tend to regard any deviation from the arm's length standard as an attempt to manipulate the tax base, there is ample evidence from business research that large-scale deviations from the arm's length standard are due to valid business considerations.", in SCHÖN (2011), p.41.

[64] This idea is also pointed by MORAIS (2006), p.886-887.

[65] The same concern is also raised by Advocate General Kokott in September 2009, at his opinion regarding the case law *Société de Gestion Industrielle (SGI) v. État Belge*, Case C-311/08, para.73: "If such transfers were to be recognised for tax purposes, companies within a group could choose freely the Member State in which profits are to be taxed, regardless of where they were generated."

defended as a business concept as it generically misses the efficiency requirements within the firm"[66], assuming, instead, the role of a legal concept.
This issue, among others, will be discussed throughout this thesis, as the ALP seems to fail the business purpose of MNEs, demonstrating some limitations regarding the wide economic global scenario where these companies currently transact.

2.4. Transfer pricing methods

To determine if a certain price is in accordance with the ALP a comparability analysis must be made based on the five methods recommend by the OECD TPG, which will verify whether the conditions settled by the related parties are in line with the principle: the traditional transactional methods[67] (comparable uncontrolled price method; resale price method; cost-plus method) and the transactional profit methods[68] (transactional net margin method and the profit split method)[69]. Between the methods provided by the Guidelines, the OECD seems to show a preference for the application of traditional methods over the profit methods[70].

On the one hand, the OECD TPG establish a "freedom of choice" for the taxpayer to choose the specific method to be applied[71]; however, considered the circumstances, some methods may provide more accurate results than others and therefore the taxpayer's choice must be consistent, i.e. plausible.

A comparability analysis is required to take place, at first, as an essential feature for a proper application of the ALP before the choose of a certain method – entails the identification of an uncontrolled transaction that is comparable to the transaction under evaluation.
When determining the comparability, it is important to consider the existence of five distinct factors[72]:

- Characteristics of the property or services transferred

Characteristics such as physical features, quality, intangible property involved and others, may be useful for comparison;

- Functions performed by the parties

Several factors, such as functions performed, assets used and risks assumed, can have a direct influence over the price of the transaction;

[66] SCHÖN (2011), p.8.
[67] These methods focus the analysis on the transactions and the prices charged.
[68] The analysis made by these methods is based on the transaction, taking into account the element of profits.
[69] OECD (2010a), para.2.1.
[70] *Ibid*. para.2.3.
[71] *Ibid.* para.4.9.
[72] *Ibid.* para.1.36 and 1.38.

- contractual terms

Usually determine how the responsibilities, risks and benefits are to be divided between the parties;

- economic circumstances of the parties

The economic circumstances that can be determinant for the comparability procedure may diverge from one market to the other;

- business strategies pursued by the parties

To analyze the business strategy of a specific company several factors need to be considered, such as innovation, product development, diversification, and many others.

Even two distinct companies that produce the exact same good or service can follow different business strategies, that for instance can include market penetration or market expansion. Naturally, this may lead to extremely difficult assessment problems.

Comparable Uncontrolled Price Method

The CUP method compares the price of a transaction between related entities in a controlled business environment with the market price, by reference to a similar transaction established between unrelated entities in similar circumstances.

If a comparable situation exists this is the preferred method, since is the most direct and reliable method, especially for manufactured goods or other products sold on public commodity markets[73]. Although, this method is not appropriate to set the price for intermediate assets, as to goods that are intimately dependent of intangible property.

Is important to note that adjustments are possible to made in two cases, if the conditions between the parties are not identical: the differences do not materially affect the arm's length price; or reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Resale Price Method

This method defines as its starting point the market price at which products are sold to unrelated parties. A suitable markup – containing the value of sales, other costs from activities performed, and a reasonable margin – is then decreased from the market price, setting the arm's length price for related transactions.

Cost-Plus Method

The method starts by distinguish the direct and indirect costs that can be attributable to the related seller, and other costs that cannot be assign to the related transaction. With reference to a gross profit margin earned by suppliers in a comparable uncontrolled transaction, an appropriate amount of profit is added to these costs, which reflects the activities performed and overhead costs.

The determination of transfer price according to this method is based on the total costs incurred by the related producer.

[73]ARNOLD & MCINTYRE (2002), p.61-62.

Transactional Net Margin Method

The TNMM uses an operational net margin that is applied over a certain economic indicator, for example costs, sales or assets. The result provides an arm's length ratio of profits that is compared to an independent transaction, operated under similar circumstances – the transfer price is then accepted by tax administration if it falls within the arm's length range of the comparable transaction.

It may be helpful for the determination of transfer prices related to tangible and intangible property.

Profit Split Method

This method is traditionally applied when the traditional methods are not suitable.

For situations where intra-group transactions reveal a high level of integration, making it extremely difficult, or even impossible, to apply a separate approach for each related member.

The PSM computes the worldwide taxable income of the related companies, which is then proportionally distributed amongst the related affiliates according to the participation that each member had to attain that profit – seek to obtain the result that better reflects the ALP.

Regard intangible property, the use of profit split method may provide a solution built on the parties' relative contributions to the development of the intangible.

The fact that the OECD TPG refer a "most appropriate method" approach "does not imply that all methods will have to be tested."[74] Indeed, the preference of Working Party Nº6 for traditional methods is of practical nature: the combination of an internal comparable with traditional methods is a "low-hanging fruit", both for taxpayers and tax administrations.

Despite the preference shown by OECD, caution should be advised considering the lack of information needed to execute a proper comparability analysis.

Taking into account the strengths and weaknesses of each method and the known factual data (for example the product, conditions, risks, activities performed, costs, contractual terms, intangible property, geographical location, even the market and its behavior)[75], the chosen method must be the one who demonstrates more appropriateness to the circumstances of the case.

2.5. Arm's Length: merits and pitfalls

The OECD has always expressed a firm "stay-the-course attitude"[76] towards the ALP as can be observed in the OECD TPG, where several advantages from its application are

[74] RUSSO & BOYKIN (2008), p.4.
[75] OECD (2008), p.6.
[76] "In fact, no legitimate or realistic alternative to the arm's length principle has emerged.", in OECD (2010a), para.1.15.

pointed[77] - the statement of grounds present in the Guidelines can be seen as the generally agreed-upon justification of the ALP to govern transfer prices issues.

As the method recommended by the OECD, the ALP expresses the international consensus[78] for the most effective way to counter transfer pricing schemes, assuming therefore a positive contribution to reach a level of certainty and predictability in an international business and taxation environment. The broad acceptance – wide and uniform implementation – reveals to be one of the strongest points of the principle.
Against this background, moving away from it would not just threaten the common ground that has been created, but would also increase "the chances of conflicting allocations that lead to double taxation"[79].

Secondly, from the perspective of taxation policy the arm's length standard contributes to tax equality and neutrality – two core principles in tax law –, and with this assures an equal tax treatment between associated corporations and independent enterprises[80].
Thus, it prevents the distortion of competitive positions by avoiding tax advantages or disadvantages, which is mandatory to guarantee the market equilibrium. Ultimately, the ALP is able to stimulate the growth of international trade and investment by eliminate any tax motivations from economic decisions[81].

Regardless the "significant cases in which the arm's length principle is difficult and complicated to apply" – namely, integrated production of goods and intangibles –, the principle is regarded to work in an effective way for the "vast majority of cases"[82].

The element of comparability analyses, at the core of ALP, is also capable of provide the closest approximation between two different economic realities, since it attends to the specific facts and circumstances of the intra-firm transaction and uses the normal market activity as a benchmark. In this respect, the standard is used to determine the true and actual prices of related transfers[83].

Finally, the inherent flexibility to adjust to new challenges and business realities, such as global trading, intangibles or information developments, is also another valuable feature mentioned by advocates of this principle[84].

As previously mentioned, the ALP is under heavy criticism by the international community, passing through a critical breaking point as the globally accepted and applied

[77] OECD (2010a), Preface, para.6 et seq.
[78] "(…) to establish a substantial body of common understanding among the business community and tax administrations.", in OECD (2010a), para.1.15.
[79] RECTENWALD (2012), p.436.
[80] WITTENDORFF (2010), p.7.
[81] OECD (2010a), para.1.8.
[82] *Ibid.* para.1.9.
[83] *Ibid*. para.1.14 and RECTENWALD (2012), p.432.
[84] NEIGHBOUR & OWENS (2002), p.956.

standard. Despite the known merits, several authors have contested the viability of the principle by exposing its weaknesses and shortcomings[85].

One of the main pointed critics lays on the foundations of the arm's length principle, since a separate entity approach fails to reflect the economic reality of MNEs, as integrated enterprises arise to achieve an international dimension and relatedness (synergies) that enables to decrease inefficiencies and to take advantage of economies of scope and scale[86]. The treatment of such relatedness "as incidental to intra-firm transactions is the economic fallacy at the heart"[87] of the arm's length principle.

Another argument that is constantly referred concerns the lack of comparables. If one remembers the background of ALP, developed in a low tech, bricks-and-mortar economy, a profound contrast is possible to establish against a current high-developed tech and economic scenario, where intangible property and new forms of communication prevail.

The "belief" that comparable transactions can be found amongst unrelated enterprises and that they can provide a suitable benchmark to determine the arm's length price for controlled transactions is declared to be another "fallacy that lies at the system's central core"[88] [89].

Indeed, there are specific markets where the creation of MNEs and the existence of enterprises acting under common control poses advantages, therefore being "unlikely that reasonably close uncontrolled comparables can be found"[90].

Considering this argument, the reconstruction of an arm's length reality with reference to what independent and unrelated parties would have done under similar circumstances, assumes the form of a Sisyphean task, since the "existence of comparables is based on an illusion about the open market."[91].

Consequently, the prices evaluation, adjustments, and ultimately the ALP are based on pure estimates instead of solid information and accurate elements, that lead to uncertainty and systematic impreciseness[92].

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[85] In this context see: KOFLER (2013), SCHÖN (2011), PICCIOTTO (2012), WITTENDORFF (2010), RECTENWALD (2012), AVI-YONAH (2009), AVI-YONAH & BENSHALOM (2011).
[86] KOFLER (2013), p.648.
[87] RECTENWALD (2012), p.437.
[88] AVI-YONAH (2009), p.7.
[89] Consider the 1989 U.S. case law *Bausch & Lomb Inc. v. Commissioner*, 92 T.C. 525. It was here discussed the license of technology for manufacturing soft contact lenses, by B&L Parent to wholly-owned Irish subsidiary B&L Ireland, and subsequently the sales of manufactured contact lenses from the subsidiary to the parent company. In this case, the application of a comparability hypothesis prevents us (and apparently the Court) from capture the true motivation behind the operation.
Instead of examining whether an independent company comparable to B&L Parent would have been interested to close a deal on licensed manufacturing, the examination was strictly concerned about how the transactions would have been priced between unrelated parties, i.e. at an arm's length price. This is heavily criticized from an economic view, since the Court only applied the arm's length principle to the subsidiary's behavior.
[90] AVI-YONAH & BENSHALOM (2011), p.377.
[91] WITTENDORFF (2010), p.11.
[92] RECTENWALD (2012), p.434.

The creation of an incentive to decrease the amount of payable tax by artificially allocate the profits in low-tax countries – whether through relocation of real economic activities, or through profit-shifting – is also regarded as a drawback of ALP[93].

The arm's length approach is extremely complex, which further results in large amounts of resources spent either by taxpayers and tax administrations. The documentation requirements[94] dictate a high-level of compliance costs and administrative burden for MNEs, due, in part, to "the highly subjective nature" and "vagueness" of this principle[95].
For tax authorities, on the other hand, this conducts to substantial enforcement costs, since effective tax assessment can prove to be time-consuming and require specific skills[96].
It is certain that the actual burdensome and transfer pricing rules represent an obstacle to MNEs profit shifting, through the referred degree of documentation these enterprises are required to reveal, but it "[comes] at the tremendous costs associated with compliance, administration and litigation."[97].

Although the ALP is stated and enforced as the regulatory standard for income allocation in international and national law, one must recognize that fiscal problems arising from profit allocation amongst related parties is a problem that remains to be resolved.
Neither side is pleased with the current tax system: fiscal authorities continue to report the employment of transfer pricing strategies by large corporations as a means for tax avoidance; whilst, MNEs have to deal with heavy compliance requirements (and respective costs), dealing at the same time with the risk of double taxation.

Thus, as a norm of international dimensions in tax matters, the arm's length principle is now under a great strain, especially from those who claim the need for a paradigm change.

[93] As we can see in RECTENWALD (2012), p.426, the Author's view is absolutely contrary to what is stated in OECD Transfer Pricing Guidelines 2010, para.1.8.
[94] "(…) with respect to documentation requirements [a compromise should be developed to] reduce compliance cost by providing clearer more definite guidance for EU tax administrations and businesses, [therefore] provide for the smooth functioning of the Internal Market.", in Commission of the European Communities (2001), p.346-347.
[95] Rectenwald goes even further by stating that the arm's length principle "is a failure because it is based upon a legal fiction that complicates and obfuscates instead of clarifying and simplifying.", in RECTENWALD (2012), p.440.
[96] ASAKAWA, p.3.
[97] Some Authors actually classify this as a "Pyrrhic victory", in AVI-YONAH & BENSHALOM (2011), p.379.

Chapter III – Is there an alternative to the Arm's Length Principle?

3.1. Unitary Taxation – A paradigm shift

Since 1930's, when the "separate entity approach" was first internationally agreed to cope with transfer pricing, it was already, at the time, discussed that in practice tax administrations should have a holistic view at company's overall accounts so that a fair split of the total profits amongst the affiliates could be obtained[98].

An increased use of "transactional profit methods" over the last years, indicates a slight change towards unitary taxation. Indeed, the European Commission proposal for a unitary system (CCCTB), confirms this idea as the "first formal international proposal for a unitary approach"[99].

In the past, fiscal authorities "(…) did not have the right to demand information about enterprise's business establishments in other states, [since it] could contribute to animosity, (…) differences in accounting principles, languages, currencies, etc. would create problems"[100] and difficulty to agree on "(…) general global principles [to solve] the issues of international allocation of the tax base of international business"[101] was a clear gap. However, the phenomenon of globalization alerted the countries to the major difficulty to tax MNEs on their overseas profits, and so focus was given to a more territorial basis.

Under unitary taxation, multinational corporations would be treated as a "single unit, disregarding the formal distinctions among its constituent corporations"[102], and, therefore, would be taxed according to their genuine economic presence in the countries where they (truly) operate, through a predetermined income allocation formula – as corporate citizens this would also assure a fair contribution towards the expenses of public resources in states where companies perform their business activities.

Against this background, a unitary approach would bridge the widening gap between international tax system and economic reality, by assuming the undeniable fact that MNEs are created to enhance economic activities on a large scale and to optimize synergetic effects. On the contrary, the treatment of each affiliated member as a separate entity cannot reflect such business reality.

In the words of PICCIOTTO, such solution would be "far more legitimate, [efficient] and simpler to implement than the current system", as the Author refers that the current

[98] The 1933 Carroll Report did contemplate the possibility of a unitary approach, although as an "exceptionally" to "separate accounting method": "Carroll recommended that (…) an apportionment method should only be used exceptionally, if it was impossible to use the separate accounting method.", in WITTENDORFF (2010), p.91.
[99] PICCIOTTO (2012), p.4.
[100] WITTENDORFF (2010), p.91.
[101] PICCIOTTO (1992), p.37.
[102] AVI-YONAH (2013), p.2.

international tax system, under a "separate entity approach", provides corporations with a vast range of possibilities to shift profits around the globe in a way that best suits their tax interests.

The consideration of each multinational company as a single entity, would have its basis on the submission of a "single set of worldwide consolidated accounts in each country where it has a business presence"[103].

In our opinion, considering the features of the present economic market dynamic, a unitary approach would represent an interesting step towards a more coordinated and consistent international tax system.

For a better understanding of the unitary system, it is crucial to undertake a brief analysis of the elements that form its central core, namely the combined report, the definition of unitary business and the allocation formula.

- Combined Report:

Under combined reporting, associated enterprises that are part of a unitary group are treated as one single entity – whole concept of the firm. Therefore, a combined report regarding the whole of the multinational group involved in the unitary business is required by each tax authority.
Once we are dealing with consolidated accounts it is sustained that eliminates distortions and tax planning opportunities by disregarding all internal transfers.
This is perceived as a key element, capable of level the playing field against the use of tax havens and secrecy.

- Unitary Business:

The adoption of a unitary business concept, within the framework of unitary taxation, can be reasonably straightforward if one is dealing with related parties whose business is vertically integrated.
Against this background, it should be applied to all the separate parts of a corporation that are "under common control or direction"[104] and "engaged in the same or related business activities"[105].
Thus, unitary business is traditionally regarded as a group of distinct members of a single entity or as a group under common control, that is organized to "(…) provide synergy and mutual benefit through functional integration, centralization of management, and economies of scale."[106]

- Allocation Formula:

[103] PICCIOTTO (2012), p.1.
[104] A broader test of control is here recommended to prevent tax avoidance, instead of the traditional legal ownership threshold.
[105] PICCIOTTO (2012), p.10.
[106] Multistate Tax Commission (2011), p.1.

A unitary approach assumes that the company's worldwide profits result from the combined activities and involvement established within the group.

Indeed, the application of a formula that uses specific factors, such as sales, assets and labour, would reflect this relationship of the individual group members activities relatively to the group's total income, as it would "provide a measure of the extent of the activities of the TNC in each country where it does business (…)"[107].

Therefore, income will be computed and apportioned with reference to factors that are able to quantify the firm's activities truly performed in each jurisdiction.

3.2. Formulary Apportionment: the concept

Global jurisdiction to tax is currently divided by a maze of international tax rules. To overcome the present tax problems, academic literature and tax experts refer the FA as the most valid alternative to ALP. Although, as MORSE questions: "Would formulary apportionment [economically and politically] fix it?"[108]

Formulary apportionment can be defined, in the words of the European Commission, as the method by which "(…) a company distributes, or apportions, its total income across the locations where it does business using a formula based on the share of activity it conducts in that location. By using a formula to distribute total profits across locations, the company does not need to calculate the profits earned by each member of the group in each location."[109] At the formula, a "weighted average of geographically specific apportionment factors, such as payroll, assets and sales" [110] will be considered – as traditionally used in several U.S. States with the so-called "Massachusetts Formula"[111].

An approach under this method requires a "three step system"[112]: determination of the MNE boundaries, for tax purposes; accurate determination of the global profits; and establishment of the formula for allocating the global profits amongst the involved tax jurisdictions.

At this point, one can identify the structural difference between the two standards. A separate entity approach is based on an individual consideration and taxation of the group's associated enterprises, as if they operate independently and under the conditions of an atomistic market; whilst, under a unitary entity approach, affiliated entities engaged in a common enterprise are to be considered and taxed as if they were a single corporation.

[107] PICCIOTTO (2012), p.11.
[108] MORSE (2010), p.594.
[109] European Commission (2005), p.9.
[110] TING (2013), p.33-34.
[111] AVI-YONAH & CLAUSING (2007), p.12.
[112] OECD (2010a), para.1.17.

A reflection about what is the best (or at least suitable) method to determine the correct transfer price takes on greater importance if we bear in mind the imperfections[113] of the current legal tax regime, especially regarding intangibles, highly-integrated corporate frameworks and lack of unrelated comparables.

From the OECD perspective, the use of FA is "actively discouraged (…) on the grounds that [it is] arbitrary and does not satisfy the norm of arm's length standard."[114] Indeed, a "[g]lobal formulary apportionment, sometimes mentioned as a possible alternative, would not be accepted in the theory, implementation, or practice."[115]

3.3. The pros and cons of Formulary Apportionment

For years the possibility of adopting FA as an alternative to ALP has been considered by several policymakers and commentators. Although the potential of FA, one must remember that "not all that glitters is gold", and so, also this method exhibits drawbacks.

Regardless the strong critics posed by the OECD to FA, the awareness of this Organization towards its claimed benefits, as stated by the Guidelines, is by itself remarkable[116]. The OECD refers that this method has been advocated on several fundaments: the "administrative convenience" it should provide; the better alignment "with economic reality", but also with "the business realities of the relationships among associated enterprises"; the inappropriateness of ALP to deal with "highly integrated groups"; and a decrease in "compliance costs for taxpayers".

However, these arguments do not convince OECD, once it continues to not consider formulary apportionment as "a realistic alternative to the arm's length principle"[117].

The OECD reasoning in this matter mainly involves applicability issues, by expressing a "most significant concern (…) [related to] the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation."

Second, OECD addresses the extreme difficult challenge of reaching common ground amongst all countries on an international predetermined formula. Needless to say, it raises a concern around the political and administrative complexity that such coordinated action would demand.

Third, it mentions the arbitrariness that a predetermined formula would entail, causing the disregard of specific facts and circumstances, such as market conditions or geographical disparities.

Under the eye of OECD, exchange rates may also be an obstacle for the implementation of FA.

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[113] We do not go as far as Rectenwald, by classifying the arm's length principle as a "failure", in *supra* note 94.

[114] EDEN (2009), p.612 and OECD (2010a), para.1.25.

[115] OECD (2010a), para.1.15.

[116] OECD (2010a), para.1.19 et seq.

[117] OECD (2010a), para.1.21 et seq.

Moreover, and against the doctrinal understanding, the OECD argues that FA would "present intolerable compliance costs and data requirements because information would have to be gathered about the entire MNE group and presented in each jurisdiction (…)". In our opinion, this argument is worthy of closer attention, since the BEPS Action Plan, namely Action 13[118], along with the implementation of the country-by-country reporting, (already) leads to a significant increase in the compliance obligations of MNE groups. Therefore, we believe that the documentation requirements enforced under a FA context, are already available (at least the bases) under the current international tax regime.

Finally, the OECD contra arguments that FA would be unsuitable for cases of intangible property valuation. Despite the undeniable difficulty to achieve accurate results in the field of intangibles, we have the opinion that such determination could be done in accordance with the criteria of where R&D activities takes place[119].

At this point, one should recognize the greater effort of the OECD to present a more detailed list of obstacles to FA than a list of its merits.

Distortions may also arise under FA, as examined by WEINER, that alerts to the innermost relation between the factors and the firm's decisions, in a context where profit allocation is made in accordance with firm-specific factors, and therefore, being able to distort the corporate business decisions[120].

The Author also observes another negative key point, which is the possibility of adoption of two distinct approaches (ALP and FA) by two different countries. This would result on the lack of common ground to establish necessary adjustments. Additionally, there would be a need either by taxpayers and tax administrations to maintain experts in ALP, with all the costs and issues that such structure would entail[121].

Tax planning happens today on a regular basis, almost as a firm's ancillary activity. It would therefore be deceitful to believe that such phenomenon would only happen within an ALP system. If under a separate entity approach, tax planning assumes the form of an artificial profit shift through internal price manipulation, under formulary apportionment it would likely be undertake through a manipulation of the factors' location, such as payroll or assets[122].

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[118] Reveals the OECD intention to "develop rules regarding transfer pricing documentation (…) [that] will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template", in OECD (2013b), p.23.
[119] AVI-YONAH (2013), p.3.
[120] Weiner also mentions the existence of a direct and indirect effect caused by the distortion: the first, concerns the effective taxation of the factor; as the second respects the variation of the tax rate in a certain jurisdiction, when compared to the average tax rate of the other jurisdictions. In WEINER (2002), p.525.
[121] WEINER (2002), p.529.
[122] WEINER (2002), p.527-528.

Despite the flaws that FA may prove to have, its merits are normally analyzed by contrast to ALP.

Advocates of this standard sustain that a shift of paradigm would be justified on several grounds[123]. The most important argument is considered to be the correction of the structural flaw of ALP, by treating MNEs as a single unity and that way reflecting the synergetic advantages of a modern integrated globalized reality. However, if we bear in mind the teachings of WEINER, we have serious doubts regarding the allegations that FA would prevent tax planning from being facilitated[124] through a contractual allocation of functions, risks and intangibles, and further, that it would reduce administrative burdens.

Differently from a separate approach, FA does not rely on "economic studies that try to "estimate" arm's length prices in the absence of meaningful benchmarks", i.e., due to tax liabilities based on the multinational group's global income, there is no need to find comparable transactions that took place amongst independent parties[125], nor to consider the internal transactions that occur within the associated members of the group.

It is precisely the ALP lack of connection with economic substance of intra-firm transactions, that constitutes the cornerstone of FA.

The versatility of an allocation formula is also viewed as an advantage, since it "(…) could be applied toward specific sources of MNE income."[126]

The combination of different countries' international tax rules often leads MNEs to devote their time and resources to explore legal tax loopholes, in a pursuit of tax incentives that may affect their economic decisions. Thus, design an adequate and acceptable apportionment mechanism presents substantial political and co-operation problems. Considered the question of the factors used in the formula and the impact that they would have on countries' fiscal revenues under a FA system, it is possible to foresee the challenge to reach a consensus about the economic factors that should be included and their respective weight in the formula.

3.3.1. Why a destination sales-based formulary apportionment?

As we can see by examine the U.S. system, formulary apportionment traditionally uses three factors to allocate the corporate income: labour, assets and sales[127].

Considering this, the individual factors included in the formula will ascertain where the profits will be taxed, therefore creating "(…) an implicit tax on the factors (…)"[128].

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[123] WITTENDORFF (2011), p.248.

[124] "(…) MNEs would have to allocate the taxes by a formula that is based on easy-to-observe and difficult-to-manipulate factors", in AVI-YONAH & BENSHALOM (2011), p.390.

[125] AVI-YONAH, CLAUISING & DURST (2009), p.511.

[126] AVI-YONAH & BENSHALOM (2011), p.380.

[127] The use of a formula that "(…) comprise[s] three equally weighted factors (labour, assets and sales)" is also proposed by the European Commission, in European Commission (2011), p.14.

[128] AVI-YONAH & CLAUSING (2007), p.12.

Naturally, it should be noted that introducing factors such as labour or assets would have the effect of discourage the in-state location of property and employment. Based on this major concern that reaches an economic and social level, preference should be given to the sales factor to quantify the economic activity.

Moving away from an unsuitable arm's length standard, a destination sales-based formula would implement a far simpler regime that would only be focused on the demand side.
Furthermore, sales are a realistic element, meaning that corporations would have less room "(…) to undertake tax avoidance strategies (…) since [they] have no control over where customers are located."[129]

Multinational corporations are created in order to achieve highly profitable results, thus, even in high-tax jurisdictions, companies will have a strong motivation to sell.

Finally, from a political angle, countries may consider the adoption of a destination sales--based formula with the purpose of preserve the elements of labour and assets that otherwise would be attracted to countries where these factors are not included in the formula[130].

3.4. Formulary Apportionment in the EU: Common Consolidated Corporate Tax Base

Since the Ruding Report, in 1992, the European Commission has been "searching for a more effective basis for corporate taxation" within the European arena[131].

The idea of a new strategy for EU company tax policy started to become more than just a whisper in 2001, with a proposal presented by the European Commission.
It is stated by the Commission that a "comprehensive approach" based on a consolidated corporate tax base for European activities, would be more appropriate to deal with a majority of tax obstacles to Single Market than a "piecemeal approach"[132].

It is important to mention that the initial proposal of the Commission has identified four "technical possibilities" for a consolidation taxation: home state taxation; common consolidated corporate base taxation; EU corporate income tax; and a compulsory harmonized tax base[133].

[129] AVI-YONAH, CLAUSING & DURST (2009), p.538.
[130] It would be in "countries' economic interest to avoid the implicit tax on assets and payroll that is embedded in a formula that relies excessively on these two factors.", in AVI-YONAH, CLAUSING & DURST (2009), p.510.
[131] PICCIOTTO (2012), p.15.
[132] European Commission (2001), p.41.
[133] *Ibid*, p.16.

The merits of such proposal soon started to be pointed: arm's length transfer pricing was no longer needed for tax purposes; tax-based distinctions between members would disappear; cross-border mergers would not incur adverse tax consequences; and cross-border loss offset would automatically occur[134]. There was a general and strong conviction that this was the way to achieve a "greater efficiency, effectiveness, simplicity and transparency (…) [and thereby] to reap the full benefits of the Internal Market"[135].

Detailed work started to be formally developed in 2004 through a working group until 2008[136]. In 2011, and as response to the Euro crisis, the Commission published a Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)[137], which is highlighted as "an important initiative on the path towards removing obstacles to the completion of the Single Market"[138].

Under the proposal of CCCTB a set of common rules would be defined for all participating members for determination of the corporate tax base, on a consolidated basis for all the members of the corporate group (a common European tax base). The Member State where the corporation was headquartered would be responsible for the administration of the (common) tax base. Profits would then be apportioned amongst the participating states according to a pre-established sharing mechanism based on a formula, and would be taxed according to their national tax rates[139]. The general apportionment formula would comprise three equally weighted factors (labour, assets and sales).

While the consistency of the national tax regimes is guaranteed by the common approach, tax rates would not be harmonized, expressing the Commission awareness towards the importance of states' sovereignty on fiscal matters. Hence, Member States will continue to preserve the power to define their own tax rates, in line with the assumed objective of a "fair tax competition (…) [that considers] their market competitiveness and budgetary needs" [140].

With respect to transfer pricing the Commission makes a statement that is, in our opinion, applaudable, by recognizing the use of arm's length approach as "[a] key obstacle [for] the single market". The Commission continues, stating that "(…) the way that closely-integrated groups tend to organize themselves strongly indicates that transaction-by-transaction pricing based on the 'arm's length' principle may no longer be the most appropriate method for profit allocation"[141], and therefore, internal transactions are to be disregarded.

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[134] WEINER (2002), p.520.
[135] European Commission (2001), p.16.
[136] PICCIOTTO (2012), p.15.
[137] The Commission assumes the goal of "tackle some major fiscal impediments to growth in the Single Market (…) [namely] over-taxation and double taxation, (…) administrative burdens and high tax compliance costs.", in European Commission (2011), p.4.
[138] European Commission (2011), p.4.
[139] WEINER (2002), p.521 and European Commission (2011), p.8.
[140] European Commission (2011), p.4.
[141] *Ibid.* p.4.

The CCCTB assumes the goal of "tackle some major fiscal impediments to growth in the Single Market (…) [namely] over-taxation and double taxation, (…) administrative burdens and high tax compliance costs"[142]. The allowance for a single compliance of a single set of rules in a single State, creates the tax environment of a "one-stop-shop".

3.4.1. The viability of the Proposal

The word "consolidated", present in the acronym CCCTB, is a living proof of the EC ambition to take a major step towards fundamental tax reform in Europe. In accordance with art.115º TFEU and the principles of subsidiary and proportionality, the Proposal falls within the EU competence to stipulate legal measures of approximation that can affect the completion of the Internal Market[143].

As already mentioned, several advantages can be related to this proposal that appears to be a "dream come true" for MNEs and for the achievement of a full-fledged Single Market.
However, it is crucial to have a complete overview of the effects and implications that a change to formulary apportionment in the EU could promote.

At the heart of CCCTB lays the mechanism of sharing the consolidated tax base between Member States. Such approach is an absolute contrast from a profit determination based on an arm's length standard, and as concluded by the EC, the results are of difficult assessment[144].

The fact that the Proposal is only applied to purely internal situations, namely, to the members of the corporation that are resident in Member States, is frequently pointed as a major limitation[145]. Consequently, the relations with non-EU entities will continue to employ an arm's length approach.
As PICCIOTTO notes, the main advantage of a unitary approach is therefore affected (at least, partially), once "(…) it allows TNCs to exclude intermediary entities which they use for tax avoidance, including those located in [tax] havens."[146] In our opinion, and in line with RIEDEL & RUNKEL[147], the concern for a potential increase of profit shifting to tax havens that have their location outside the EU is justified, as a harmful effect derived by CCCTB.
In this regard, PICCIOTTO suggests that a better approach "would be to require submission of a worldwide combined report."[148] Although we admit that this would be an ideal solution for most of the current tax problems, we have serious doubts regarding the

[142] European Commission (2011), p.4.
[143] European Commission (2011), p.9.
[144] "In fact, the impact [of CCCTB] on the revenues of Member States (…) is difficult to predict", in *Ibid.* p.9.
[145] PICCIOTTO (2012), p.15.
[146] *Ibid.* p.15.
[147] RIEDEL & RUNKEL (2007), p.1534.
[148] PICCIOTTO (2012), p.15.

feasibility of this suggestion that would likely prove to be unrealistic from a political perspective.

The EC mentions that the Proposal "(…) as an optional system, represents the most proportionate answer to the identified problems."[149] One must consider that a stipulation of optional nature will always create the need for "(…) two parallel systems running at the same time (…)"[150] – the proposed new system (based on unitary taxation) and the existing national rules (based on separate entity taxation). Naturally, "tax administrations will have to manage two distinct tax schemes", a fact that EC perceives that is "compensated" by other advantages[151]. The question that should be done is whether the compliance and costs created by the coexistence of two different systems outweighs the current cost element.

However, the 2016 Proposal has already (partially) mitigated this problem, stating that CCCTB "would be mandatory for groups of companies beyond a certain size, namely those with a consolidated turnover exceeding €750 million"[152]; remaining optional for the rest of companies.

In today's economy intangible assets play a significant role, thereby ignore this major profit driver is likely to cause arbitrary and unreliable results. However, this was not the Commission's understanding, since it considered that "[i]ntangibles should be excluded from the formula due to their mobile nature and the risks of circumventing the system."[153]

According to RÖDER, the arguments presented by the EC, that "intangibles are indirectly included in the apportionment formula via researchers' salaries and research assets" are not meaningful, and present no correlation with the real "value of intangible assets actually generated"[154].

The possibility to include acquired intangible assets with reference to the historical cost, is not compatible with self-generated intangibles, that would require an annual evaluation with reference to a fair market value – it is likely that a feasible evaluation would not be obtained at an acceptable cost[155]. In addition, a solution that only excludes self-generated intangibles would be considered as clearly arbitrary.

We agree with RÖDER when he claims that the exclusion of intangibles from the formula is "problematic". While the risks of tax planning opportunities and tax compliance can be held as a valid justification, we are not so sure about the mobility argument presented by the Commission.

Furthermore, we are far from being convinced about the Commission's explanation that CCCTB would decrease the distorting effects of an unfair tax competition within the Internal Market.

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[149] European Commission (2011), p.10.
[150] HASKIC (2009), p.12.
[151] European Commission (2011), p.6.
[152] European Parliament (2016), available at: http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/599395/EPRS_BRI(2017)599395_EN.pdf
[153] European Commission (2011), p.14.
[154] RÖDER (2012), p.133.
[155] TEMME, SPORKEN & OKTEN (2011), p.329.

If on one hand a consolidated and uniform tax base creates transparency, on the other an intensification of tax rate competition appears as a realistic scenario[156] - raising the concern for a tax "race to the bottom". A survey made by KPMG is able to demonstrate the disparity between effective corporate tax rates amongst the EU Member States[157]. It should be paid attention to examples such as France and Ireland[158] as opposite tax realities within the same economic zone.

Finally, once the apportionment of the consolidated tax base is determined by the CCCTB formula, the included factors (equally weighted in the formula) will naturally be considered for tax planning opportunities[159].
The allocation factors will exercise a direct influence on the company's profit, as well as on the payable tax in each Member-State. Therefore, strategic decisions related to the factors (specially labour and assets) will be dependent on the formula used, which leads to distortions since the apportionment will not be made in an accurate way. For example, "there would be an incentive to outsource activities in high tax countries [so] associated assets and workforce would be eliminated from the asset and labour factor."[160]

3.5. A clash between two realities: Formulary Apportionment vs. Arm's Length Principle

Initially, the creation of ALP was based on the necessity to encounter international profit distortions and to avoid double taxation. Albeit, the world on which it was implemented has been changing in a continuous process, giving rise to an utmost concern expressed by several tax experts and "economists [that] arm's length principle is contrary to economic reality." In fact, this is acknowledged as a structural problem of the method since it assumes "(…) that every subsidiary and permanent establishments within a group is a separate entity which conducts trade under free-market conditions with entities in the group."[161]

Integrated organizations and global trade are reflective of the multinationals' pursuit for a profit maximization – that may include deceptive tax planning schemes to shift profits towards more attractive jurisdictions.
The fact is that ALP is frequently pointed as a powerless method to capture the real purpose of economies of scale and scope perpetrated by large corporations. It is precisely this difficulty in applying the ALP to global financial trading that constitutes a major argument in benefit of a unitary approach.

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[156] MAYER (2009), p.265.
[157] KPMG, "Corporate Tax Rates Table", available at: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html
[158] Indeed, the CCCTB may reveal to be detrimental for countries that assume a political and economic competitive tax rate.
[159] HASKIC (2009), p.9.
[160] RÖDER (2012), p.135.
[161] HAMAEKERS (2001), p.22.

Additionally, when compared to the current standard, a FA method would provide a decrease in administrative burden and compliance costs for both tax authorities and taxpayers, due to an apportionment based on internal available data.

Despite the criticisms, the ALP is still regarded as a reliable solution for situations where independent market prices are easily observable[162], or the degree of interconnection established between the members of a MNE is not considered a paramount element.

However, arm's length pricing depends on markets. Hence its vulnerability is exposed when "(…) no sufficiently-established market for unrelated-party transactions exists (…)"[163], or a significant number of intra-group relations makes it nearly impossible to administer.

As a threat to the fiscal system sustainability, tax advantages of tax havens would probably be eliminated by a well-designed FA system "(…) without the need for complex, difficult-to-administer [rules]"[164]. Indeed, the ability to manipulate transfer prices with the purpose to shift profits to low-tax jurisdictions would be prevented, once FA assumes a unitary entity determination that comprehends all the affiliates involved in a unitary business. This directly addresses the issue of inter-nation tax equity, by "(…) allowing weaker and smaller countries to obtain their fair share of tax revenue [as it decreases] the risks of harmful tax competition (…)"[165].

Another field where the arm's length approach has been showing tremendous difficulties to cope with, and that can be clearly pointed as one of its "Achilles heel", refers to transactions of intangible assets.

Once again, is important to remember the fact that these types of operations are not frequently undertake by independent enterprises. Thus, the absence of clear market benchmarks in conjunction with highly integrated corporate structures, precludes the determination of an arm's length result.

In the current economic reality MNEs "(…) exist because of their competitive advantages, foremost their [development and] control of unique technology [and intangible values]"[166] [167].

Given the OECD inability to overhaul the current system, some Authors have mentioned the possibility of a (reasonable) middle ground solution that consists in a conjunction of the two methods[168] - adoption of formulary apportionment in the context of arms' length principle, instead of replacing the arm's length principle with formulary apportionment.

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[162] AVI-YONAH & BENSHALOM (2011), p.385.
[163] KOFLER (2013), p.647.
[164] ARNOLD & MCINTYRE (2002), p.79.
[165] *Ibid.* p.79.
[166] PICCIOTTO (2012), p.8.
[167] Cost Contribution Arrangements also represent a valuable tool to the collective development of new intangibles. Every company is risk-averse, therefore, with these agreements costs, revenues and risks are shared in proportion to the contribution of each participating member. Naturally, the expected result is to lower risks and higher results.
[168] BRUANER (2014); AVI-YONAH (2009); AVI-YONAH & BENSHALOM (2011).

Notwithstanding the advantages of profit-split method, which uses comparables to allocate the return on routine functions, it often leaves a residual. This may represent an opportunity to introduce, in the actual context, a formula that allocates the residual[169]; perhaps, this could be a solution for "hard-to-measure intangibles"[170].

At the eyes of several tax experts "the arm's length principle and formulary apportionment should not be seen as polar extremes; rather, they should be [contemplated] as part of a continuum of methods ranging from CUP to predetermined formulas."[171]

Regardless of the scepticism around FA, mostly for political reasons, it is almost unanimously acknowledged that changing towards a unitary basis could guarantee a more intimate alignment between international tax system and economic reality, that way enhance its legitimacy and effectiveness.

The fallacy that is possible to identify or quantify the income that could be earned by any of the component members, would give rise to the assumption that the income of a corporation is earned by that corporation as a whole.

As AVI-YONAH and BENSHALOM describe, "[p]erfect solutions are hard to come by, [therefore] waiting for them [is just] an extremely unattractive policy trajectory."[172] It is certain that FA has its own struggles, although we tend to agree with PICCIOTTO when he refers that "these are minor compared to the problems it would eliminate."[173]

3.5.1. The particular case of European Union

The question of whether FA, as a method that seeks to determine where the real source of income is geographically located, should be introduced in the EU has been raised by several academics and policymakers.

Notwithstanding the experience of nearly a century of combined reporting, we are far from convinced that the U.S. system would provide a considerable base of support for a transition from ALP to unitary taxation within the EU. As stated by RÖDER, "[a]t the current state of integration, the EU is not comparable to a federal state as regards its financial constitution (…) [since] Member States [still] retain a much higher degree of fiscal sovereignty (…)"[174].

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[169] Since we are discussing a "residual formula" the base would already be defined by arm's length principle, and therefore would be in accordance with treaties and manageable within the scope of art.9º OECD MTC.

[170] BRAUNER (2014), p.99.

[171] ARNOLD & MCDONNELL (1993), p.1381. The same idea is stated by: ARNOLD & MCINTYRE (2002); KOFLER (2013). Indeed, pricing methodologies such as profit-split method or TNMM seem to be closer to formulary apportionment than to arm's length principle.

[172] AVI-YONAH & BENSHALOM (2011), p.381.

[173] PICCIOTTO (2012), p.10.

[174] RÖDER (2012), p.150.

Indeed, we believe that this is a deeper and more fundamental question. When compared to the U.S., the EU does not share the same homogeneity amongst its Member States, and this goes even beyond the economic factor, as the cultural and social contrast reveals a lack of uniformity[175].

Considering the diversity and the disparity of economic interests, is possible to anticipate the difficulty to reach a consensus about the factors that should be included in the apportionment formula, and their respective weight.

Although, as the European economy becomes more integrated, cooperation increases between Member States and companies gradually operate on a EU basis, "[t]he CCCTB would probably suit a region such as the EU [better] than an arm's length framework."[176]

We truly believe that if modified and properly established, the CCCTB is most likely to undertake a role of major importance "(…) in the fight against both major types of international tax avoidance, the use of tax havens and transfer pricing"[177], whilst increases a fair and efficient corporate taxation.

Moreover, in a reality where multinational corporations do not quite belong to any jurisdiction, the implementation of the CCCTB in Europe would grant, in the words of AVI-YONAH, "(…) a good working example in the context of high tax jurisdictions"[178], and could, therefore, contribute to "clear the path" for a transition from the ALP system to unitary taxation within the OECD members.

[175] It is important to perceive that EU citizens do not recognize the Community interests as their own (or national) interests. This issue is addressed by Donald Tusk, President of the European Council, at the event marking the 40th anniversary of European People Party (EPP), in 2016. Available at: http://www.consilium.europa.eu/en/press/press-releases/2016/05/30-pec-speech-epp/
[176] HASKIC (2009), p.15.
[177] PICCIOTTO (2012), p.16
[178] AVI-YONAH (2013), p.3.

Conclusion

Transfer pricing is not an exact science and the context where these operations occur can be unique in their form and nature.

Not only advances in information and communications technology has forever changed the traditional business processes, as it also contributed to a remarkable innovation across all sectors of economy, allowing for "(…) centralized management of geographical dispersed groups (…)"[179] to be an actual reality.

Internationally integrated operations are placed in the center of a new business economic stage, where comparables between independent enterprises (that frequently do not even exist) are uncapable of provide a reliable benchmark for the evaluation of complex intra-firm transactions.
The vulnerability of the actual transfer pricing regime is even more exposed if one considers the challenges that intangibles and tax havens represent to the separate accounting system, creating an enormous range of opportunities for tax avoidance.

Following the line of RECTENWALD, "[i]t is clear that transfer pricing using ALS as a mechanism for allocating the income of MNEs is broken and unsustainable in its administration and for the purposes of revenue collection."[180]
Considered the reality of an increasingly global world, the weaknesses and conceptual flaws of the current system becomes undeniable. Therefore, we are led to disagree from SCHOUERI's opinion that it would be reckless to "(…) [give]-away a half-century experience on the application [of arm's length principle]"[181].

As the bulk and sophistication of associated transactions raises, the persistence for a separate approach becomes unacceptable. Perhaps it is time to face that the ALP has failed to keep pace with the changes in global economy.

Against this background, the need to address tax planning strategies that allow large corporations to shift profits from high-tax jurisdictions where economic activity and real value creation occurs to low or no-tax jurisdictions, still remains.

An alternative to the arm's length standard, which is strongly suggested by academics, is formulary apportionment as a method based on true and readily determinable economic factors. Such system, if well-designed, would be able to eliminate several problems that currently "haunt" the arm's length principle, as it would assure an inter-nation equity (desirable for developing countries and emerging economies).

[179] AVI-YONAH (2009), p.8.
[180] RECTENWALD (2012), p.448.
[181] SCHOUERI (2015), p.703.

The scenario of a unitary taxation is heavily present on the EU agenda, as a system that would make a sizeable contribution to full accomplish the ideal of an Internal Market and a complete economic integration amongst the Member States – this possibility is even more seriously considered if the argument of Euro crisis is summoned for the discussion.

However, political challenges such as the sovereignty issue may present a problem to reach an agreement. If it is actually decided for the adoption of a consolidated base taxation with formula apportionment, further discussions will have to take place between countries in order to agree on two points: the definition of the formula; and the definition of the factors included in the formula and their respective weight on the allocation of profits between the Member States.

Either way, the fact that the European Commission has decided to walk a different path from the one recommended and accepted by the OECD is already remarkable.

Recalling the initially referred research question, *"Is the Arm's Length Principle the most efficient method to determine transfer prices and to solve the problems related to the allocation of profits amongst different tax jurisdictions? What are the alternatives, and will they perform better than the current method?"*, and considered the state of art, we conclude that both tax approaches exhibit several strengths and drawbacks. Therefore, even though there is no unanimously accepted alternative that would be capable of rectify all the current tax problems related to transfer pricing, it is important to recognize the existent growing consensus about the necessity for further harmonization in the field of corporate income taxation and for the achievement of a more appropriate solution.

Finally, the international community appears to regard with expectation what will be the EU's next step on this matter and what will be the impact of such decision, before they consider the possibility of introducing a change.

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