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In this article, the authors argue that all the proposed alternatives to the arm's-length principle lack its two key benefits of neutrality and flexibility, and they look ahead to what the future may bring.

I. Introduction

The arm's-length principle has been the cornerstone of the international corporate tax system since the League of Nations adopted it in the 1920s as the primary way to allocate taxing rights between countries. The world has changed a lot in the intervening years, and the arm's-length principle is now used in some form by almost every country to determine their taxing rights over multinational businesses.

Yet the continuing centrality of the arm's-length principle to the international corporate tax system can no longer be assumed. In 2021 a United Nations panel published a report criticizing the arm's-length principle and calling for a "simple and fair formulaic approach to taxing rights,"[1] although it should be noted that the panelists behind the paper were serving in their individual capacities rather than as country representatives. Meanwhile, the IMF staff published a book exploring alternative approaches to allocating taxing rights over corporate profits,[2] and in the opening paragraph of a recent board-presented tax policy paper the organization noted the "limitations of the arm's-length principle."[3] Even the OECD, the organization that has done the most to advance the arm's-length principle, has publicly stated that it is exploring the revision of profit allocation rules "that go beyond the arm's length principle," and it is making progress.[4] In October 2021 the OECD/G-20 inclusive framework on base erosion and profit shifting reached an agreement on pillar 1, which would fundamentally change the way a portion of the taxing rights over the largest, most profitable multinationals are allocated between

[1] United Nations, "Financial Integrity for Sustainable Development" (Feb. 2021).

[2] Ruud A. de Mooij, Alexander D. Klemm, and Victoria J. Perry, *Corporate Income Taxes Under Pressure*, IMF (2021). Similarly, World Bank Group staff recently examined different approaches to the arm's-length principle. The report noted it was a "welcome development" that the inclusive framework (in its work on digitalization) was willing to depart from strict adherence to the arm's-length principle. *See* Colin John Clavey et al., "International Tax Reform, Digitalization, and Developing Economies," World Bank Group (Oct. 1, 2019).

[3] IMF, "Corporate Taxation in the Global Economy," IMF Policy Paper No. 19/007 (Mar. 10, 2019).

[4] OECD, "Addressing the Tax Challenges of the Digitalisation of the Economy — Policy Note" (Jan. 23, 2019).

countries, moving away from the arm's-length principle.[5]

Does this mean that the arm's-length principle has reached the end of the road? Is it finally time for a completely different approach? We are not convinced and do not believe there is a better alternative. In our opinion, the arm's-length standard is the worst standard except for all the other options that have been suggested or tried from time to time. As we explored in an earlier article, the chief alternative to the arm's-length principle — formulary apportionment — is unlikely to provide an acceptable way to allocate taxing rights between countries.[6]

In this article, we focus on the two big benefits of the arm's-length principle that no other profit allocation system proposed to date delivers. First, the arm's-length principle ensures the neutrality of the corporate tax system and does not, in concept, favor developed or developing economies.[7] Any alternative allocation of taxing rights would inevitably create greater incentives for businesses to restructure their operations — an outcome that is economically inefficient and would likely disadvantage higher-tax countries. Second, as a principle, it can deliver a different allocation of taxing rights for different businesses in a principled manner. The adaptability of the arm's-length principle has enabled it to survive the transition between the second, third, and fourth industrial revolutions.

This does not mean that its supporters should be complacent. The arm's-length principle can remain predominant only if it retains widespread international support — support that can no longer be assumed by taxpayers or governments. This article considers what that means for the future of the arm's-length principle.

II. Arm's Length vs. Transfer Pricing

The arm's-length principle is frequently, but wrongly, used interchangeably with transfer pricing. The arm's-length principle is an internationally agreed principle that determines how taxing rights over the profits of a multinational corporation should be allocated between two or more countries. In adopting it, countries have implicitly rejected other principles that could be used to allocate taxing rights over multinationals, such as on a destination basis.

In contrast, transfer pricing in the broadest sense refers to a set of rules governing how multijurisdictional enterprises price intercompany transactions. These rules need not adhere to the arm's-length principle — although in most jurisdictions, they do. And it is challenging when they do not. Brazil has long applied a transfer pricing system based on fixed margins for some methods, which is difficult to reconcile with the arm's-length principle and hence the way other countries tax the profits of multinational groups. However, it is expected to soon be replaced by a system that is compliant with the arm's-length principle.[8]

Even in the United States, which has long embraced the arm's-length principle — or, as the section 482 regulations refer to it, the arm's-length standard — the equivalence between transfer pricing and the arm's-length principle is not entirely straightforward. The U.S. statute itself does not even refer to the arm's-length standard because Congress largely left the development of transfer pricing guidance to the regulatory process. Section 482 instead permits transfer pricing adjustments when "necessary in order to prevent evasion of taxes or clearly to reflect the income" of related parties. That statutory language was first enacted in the Revenue Act of 1928. The arm's-length principle was not introduced until 1935, when Treasury promulgated regulations under the transfer pricing statute.[9] Even after that, it took some time for the arm's-length principle to become accepted as the bedrock of U.S. transfer pricing, with some

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[5] OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy" (Oct. 8, 2021).

[6] Alistair Pepper, Jessie Coleman, and Thomas D. Bettge, "Why It's Still Not Time for Global Formulary Apportionment," *Tax Notes Federal*, Aug. 22, 2022, p. 1233.

[7] Joel Cooper et al., *Transfer Pricing and Developing Economies: A Handbook for Policy Makers and Practitioners*, World Bank Group (2016).

[8] *See* Roberto Salles and Kimberly Tan Majure, "Brazilian Transfer Pricing: Here Today, Gone Tomorrow?" 51 *Tax Mgmt. Int'l J.* (June 3, 2022).

[9] Reg. section 86, art. 45-1(b) (1935).

courts applying more amorphous reasonableness standards.[10] Further, in recent years, litigation concerning the validity of specific transfer pricing rules, such as the stock-based compensation rules of reg. section 1.482-7(d)(3) and the blocked income rules of reg. section 1.482-1(h)(2), has raised in some measure the question of their compatibility with the arm's-length principle.[11]

Nonetheless, departures from the arm's-length principle are the exception, not the norm. Brazil is an outlier in its approach, and the primacy of the arm's-length principle in the United States is now well established, despite some early oddities in the case law. Far from undermining the arm's-length principle, the recent litigation in the United States reinforces its foundational role, as the parties dispute — often through the lens of administrative law arguments — whether specific features of Treasury's regulations contradict the arm's-length principle.

Even when transfer pricing rules fully endorse the arm's-length principle, the objective of those rules is still fundamentally different from the arm's-length principle. Transfer pricing itself is not a principle, but rather a system or framework that establishes a series of methods (with more or less international agreement) through which the arm's-length principle can be applied. For example, the OECD's "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" prescribes methods to set or test the price of an intragroup transaction. Many jurisdictions have adopted the OECD guidelines into their domestic rules or rely on them informally as a source of guidance. In the United States, for example, internal IRS guidance states that "Treasury and IRS consider section 482 and the regulations to be wholly consistent with treaty obligations and the OECD Transfer Pricing Guidelines."[12]

This difference between the arm's-length principle and transfer pricing can be illustrated using a simple example. Assume that a multinational group consists of two entities: Entity A, resident in France; and Entity B, resident in the United States. Entity A produces wine and sells it to Entity B for resale to local U.S. consumers. The arm's-length principle describes an internationally accepted principle for allocating taxing rights over the profits of entities A and B between France and the United States that will result in the entire profits of the multinational group being taxed once and only once, assuming the arm's-length principle is applied consistently by both jurisdictions and that neither France nor the United States exempts the income allocable to their jurisdiction from tax.

Transfer pricing provides a framework for applying this principle. For example, a transfer pricing analysis in this case may determine that the transaction should be priced using the comparable uncontrolled price method if the taxpayer can identify transactions in which the sale of wine to an uncontrolled party is sufficiently similar to the sale of wine from Entity A to Entity B. However, if those transactions don't exist, the transfer pricing analysis would apply a different method.

III. This Distinction Matters

The distinction between the arm's-length principle as a principle and transfer pricing as a system is important for two reasons. First, the distinction has allowed transfer pricing rules and practices to evolve over time while remaining within the broad confines provided by the arm's-length principle. Second, this distinction highlights that if the arm's-length principle and transfer pricing were to be replaced, it would be necessary to reach agreement on both an alternative profit allocation principle and methods.

The changing approaches to the application of the arm's-length principle can be seen in a variety of places. The most obvious example is the multiple iterations of the OECD guidelines since they were first published in July 1995.[13] In some instances, those changes have merely clarified how the arm's-length principle should be applied

[10] *See Altera Corp. v. Commissioner*, 926 F.3d 1061, 1068-1069 (9th Cir. 2019) (discussing early cases).

[11] *See id.* (stock-based compensation); *Xilinx Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010) (stock-based compensation); *Coca-Cola Co. v. Commissioner*, 155 T.C. 145 (2020) (blocked income); and Petition, *3M Co. v. Commissioner*, No. 5816-13 (T.C. Mar. 6, 2013) (blocked income).

[12] AM-2007-007.

[13] OECD, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017," 3-4 (2017).

in particular instances or to specific transactions, but other changes have been more substantial. For example, the risk control framework and concept of development, enhancement, protection, maintenance, and exploitation functions introduced through BEPS actions 8-10 (and formally incorporated into the OECD guidelines in 2017) represent material changes to the way transfer pricing rules are applied to intangible property and other arrangements.[14] Changes to transfer pricing rules are not limited to the work of the OECD. Countries' domestic legislation and regulations have been repeatedly written and rewritten as tax administrations have sought to clarify how the arm's-length principle should be applied. In the United States, the most significant statutory change came in 1986 with the introduction of the commensurate with income principle, while 1994 saw the overhaul of long-standing regulations and the introduction of the comparable profits method, which is analogous to the transactional net margin method under the OECD guidelines and the emphasis on selecting the "best method."

To some people, the constant tinkering with transfer pricing rules reflects the limitation of the arm's-length principle. There will be some who argue that recently published guidance, such as that issued as part of the BEPS project, is an attempt to rewrite transfer pricing rules to deliver an allocation of taxing rights that is not supported by the arm's-length principle. However, others argue these are just tweaks and necessitate no change to domestic law (which incorporates the arm's-length principle). For example, U.S. government officials have said that section 482 regulations in their pre-BEPS form require no changes to align with the BEPS deliverables. Alternatively, some critics may claim that the repeated rule changes are a consequence of the inherent weakness of a conceptual framework that gives too much scope to taxpayers to bend the rules to achieve preferable tax outcomes.

Although the flexibility of the arm's-length principle can be seen as a weakness, it is also one of its greatest strengths. The arm's-length principle gives countries a principled basis to allocate taxing rights over the profits from businesses from different industries and of different sizes, and it has survived the dramatic changes the global economy has seen in the past 100 years. The longevity of the arm's-length principle is underpinned by the flexibility of transfer pricing, which taxpayers and tax administrations have constantly tweaked in the face of an ever-changing economic environment. It has also meant that when countries have become unhappy with the outcomes the arm's-length principle delivers, they have been able to adjust transfer pricing to deliver different outcomes, but without abandoning the underlying principle. Allowing that flexibility while adhering to the same bedrock principle has been enormously helpful. Because of the broad acceptance of the arm's-length principle and its inclusion in most bilateral tax treaties, mutual agreement procedure cases give countries a mechanism to eliminate double taxation when their views on the correct application of the arm's-length principle have initially differed. As emerging markets and developing countries have been incorporated into the global economy, and hence transfer pricing has become more important, they have also adopted the arm's-length principle, though they have taken advantage of the room the principle provides (as well as some extra room it arguably does not provide) to tailor its application to their profile.

For those that want to replace the arm's-length principle — whether that be with formulary apportionment, destination-based taxation, or some other profit allocation system — agreeing on an alternative principle for allocating taxing rights will be challenging.[15] There is always lots of focus on why a particular profit allocation method would be superior and simpler than transfer pricing, but not enough focus on what really matters to countries — the money. Adopting an alternative principle for allocating taxing rights over multinationals would benefit some countries at the expense of others. It might be possible to increase aggregated global tax revenue if average tax rates rise, but those increases would be likely

[14] *Luxembourg v. Commission* and *Amazon EU Sàrl and Amazon.com Inc. v. Commission*, joined cases T-816/17 and T-318/18, paras. 146-155 (GCEU 2021).

[15] *See* Pepper, Coleman, and Bettge, *supra* note 6.

only at the margin. And arguably, much of those marginal increases already occurred as part of BEPS 1.0.

In a world where countries retain the sovereign right to set their own tax policy, it would be difficult to create sufficient incentives for the losers of a new profit allocation system to sign up. Moreover, a country that chooses to forsake the arm's-length principle and go it alone on formulary apportionment would need to override its treaties that contain the arm's-length principle, resulting in widespread double taxation without the prospect of MAP relief, ultimately leading to significant decreases in foreign direct investment. This highlights the significant advantages the arm's-length principle enjoys as the incumbent internationally accepted way to allocate taxing rights. One of the reasons the arm's-length principle is likely to survive is because of how complex, difficult, and costly it would be to move to a new internationally accepted profit allocation system.

IV. Defending the Principle

For a concept as maligned as the arm's-length principle, it can be tempting to resort to a defense that focuses solely on the weaknesses of the alternatives. However, in our view, there are two compelling reasons why the arm's-length principle remains the best way to allocate taxing rights between different countries.

For businesses that can choose whether to perform particular operations using related or third parties, the arm's-length principle is vital for tax neutrality. If taxing rights over multinationals were not allocated on the basis of the arm's-length principle, groups would have an incentive to restructure and outsource activities performed in higher-tax jurisdictions. For example, under a destination-based system, groups with valuable intangibles (such as a fast-food chain) would have an incentive to subcontract the running of restaurants in higher-tax jurisdictions to third parties to minimize the sales booked in those jurisdictions. That incentive does not arise under a system based on the arm's-length principle.

The arm's-length principle also delivers profit allocation outcomes that can vary by business, or in the words of the BEPS project, "align profits and value creation," which is appropriate from an economic perspective. These outcomes are also equitable for both developed and developing countries. Returning to the example of the multinational group that produces wine in France and sells it in the United States, if most of the profits generated by the group are attributable to the French climate, technology, and local skills, it seems appropriate for most of the group's profits to be taxed in France. In contrast, if most of the profits are attributable to a successful U.S.-led marketing campaign that turns an inexpensive French wine into an in-demand product, it would seem more appropriate for most of the group's profits to be taxed in the United States. The arm's-length principle can deliver these different outcomes because it takes into account the fact patterns of specific businesses (the functions performed, the assets used, and the risks assumed) when allocating taxing rights between two jurisdictions. This outcome simply cannot be delivered under a more formulaic approach to allocating taxing rights, which would be unable to account for the subtle distinctions between two otherwise comparable businesses.

V. Future Outlook

The arm's-length principle may have been the cornerstone of the international tax system for the past 100 years, but this is no guarantee that it will retain this position for the next 100.

The future of the arm's-length principle rests on countries' continued acceptance that it represents a fair and appropriate way to allocate taxing rights over multinationals. As more countries have accepted the arm's-length principle and adopted transfer pricing rules, there has been a virtuous circle as it becomes more difficult and costly for countries to stand outside this international consensus. However, if countries start to question the fairness of the outcomes that result from the arm's-length principle, this consensus could quickly unravel.

A. Where Are We Today?

As recent discussions at the OECD have shown, the rapid growth of digital businesses in the past two decades poses a significant threat to the arm's-length principle. Digital businesses are able to generate significant revenue without setting up physical operations in a country and hence without that country being allocated any taxing rights under the current international corporate tax system. The concern over this issue has been exacerbated by digital businesses generating relatively large corporate profits, which are headquartered in only a handful of countries. Even when these businesses do have physical operations in a country, those local operations are rarely a key value driver and so do not attract much profit.

This is not a question of tax avoidance, as the public and press assume, but a consequence of the fact that in the 21st century it is possible to run global billion-dollar businesses with a limited international footprint. However, the large profits generated by these companies, coupled with the negative publicity on taxes, has led to the public's general perception that multinational companies do not pay an appropriate amount of tax and that the current taxing system is broken. And politicians have never had the courage to explain why this, in fact, is not the case.

In countries such as France, India, and the United Kingdom, public pressure on politicians to make digital businesses "pay their fair share" has led them to take actions that undermine the arm's-length principle. Some countries have implicitly rejected it by making aggressive (or more accurately, excessive) transfer pricing adjustments. Others have introduced digital services taxes, which generally apply to only large digital businesses (or in India, the equalization levy, which applies more broadly). These measures simply override the allocation of taxing rights delivered by the arm's-length principle. These countries generally do not want to abandon the arm's-length principle, but rather dislike and reject the outcomes it delivers for digital businesses under the existing system. The challenge they face is that once you move away from the arm's-length principle for one set of businesses, it becomes more difficult to explain why it still delivers fair outcomes for others.

The other significant challenge the arm's-length principle faces is transfer pricing. Though the two are conceptually distinct, the arm's-length principle cannot survive without transfer pricing. A principle is good only if it works in practice, and the practical application of transfer pricing rules is becoming increasingly difficult. There are various reasons for this.

In the past 20 years, transfer pricing rules have become more complex as tax administrations have placed greater emphasis on substance over form. This change in focus has led to a significant increase in the frequency of disputes, imposing costs on taxpayers and tax administrations alike. In some instances, tax administrations have weaponized new rules — for example, the new development, enhancement, protection, maintenance, and exploitation framework — to make sweeping claims to additional profits that are arguably not justified under any reasonable interpretation of the arm's-length principle. The introduction of transfer pricing rules in lower- and middle-income countries, such as Albania, Mongolia, and Zambia, has placed additional pressure on taxpayers' compliance processes, but also on the tax administrations of lower-capacity countries that lack the resources to review corporate compliance with these detailed rules. Finally, the increasing complexity of global supply chains and businesses themselves has made some of the basics of transfer pricing — for example, characterizing transactions and identifying comparables — increasingly difficult.

B. Looking Ahead

It is possible to envisage two futures for the arm's-length principle.

The pessimistic view is that acceptance of the arm's-length principle gradually declines, with different countries seeking to adopt alternative rules for allocating taxing rights. This process is already well underway. In both the developed and developing world, countries are experimenting with a variety of measures — such as DSTs, equalization levies, diverted profits taxes, or sales-focused withholding taxes — that deliver outcomes that diverge from the arm's-length principle, although many of these measures apply only to a small group of companies. Over time these types of measures could gradually spread into other sectors, or the rate applied on these types of taxes could be increased. The United States can and should push back against these measures, which primarily target U.S. businesses, as the Office of the U.S. Trade Representative has already done against DSTs using section 301 tariffs. However, there are limits to what even the United States can achieve when it is faced with concerted international opposition.

We can also expect that an ever-larger group of countries will make aggressive transfer pricing adjustments or deny deductions for legitimate intragroup costs to counteract profit allocation outcomes that they do not like. This increase in transfer pricing disputes will inevitably put further pressure on a MAP system that is already struggling to resolve the disputes we face today. If this persists, in a pessimistic scenario, it is unlikely that the arm's-length principle would go out with a bang to be replaced by an alternative system. Instead, it would go out with a whimper as international consensus breaks down over how to allocate taxing rights over the profits of multinationals. What is particularly haunting about this possibility is that the arm's-length principle would not be replaced as such but would be layered under a chaotic proliferation of divergent rules. In an era of deglobalization, this is not an outcome that can be ruled out.

It is also possible to envisage a more optimistic future for the arm's-length principle — one in which it remains the primary principle for allocating taxing rights over multinationals — but only if it receives renewed international support. In the short term that means that the international dispute around the taxation of digital businesses needs to be addressed, whether that be through pillar 1 or some other revision to the international corporate tax system. In the medium term, resolving the digital issue alone will not be enough; we also need to make transfer pricing work, or at least work better. Pillar 1's amount B is one workstream through which that may start to be achieved.[16] ■

[16]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

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