Transfer Pricing and Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Splits (Just Don't Say Formulary Apportionment)

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ABSTRACT

This paper reviews, from a practical and a theoretical perspective, some of the problems associated with the application of the arm's-length principle both in the context of transfer pricing and in the context of the attribution of profits to permanent establishments, specifically considering, in the latter case, the recent proposals of the Organisation for Economic Co-operation and Development (OECD). The two main problems discussed are the lack of certainty in applying and the difficulty of administering the OECD rules. The paper suggests that a possible solution would be to adopt, as the standard, the systematic application of global profit splits in every tax jurisdiction. This approach would not only solve in great part the problems identified in the paper; it would also potentially allow tax authorities to do away with other complex international tax regimes, such as withholding taxes, foreign tax credits, and controlled foreign corporation rules.

KEYWORDS: ARM'S LENGTH ■ BRANCHES ■ PERMANENT ESTABLISHMENTS ■ PROFIT SPLITTING ■ PROFITS ■ TRANSFER PRICING

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By international consensus, the attribution of profits to permanent establishments (PEs), just like the determination of international transfer prices between non-arm's-length entities, requires the application of the arm's-length principle.[1]

These days it seems that, even though we are virtually inundated with guidance from world tax authorities on how to apply the arm's-length principle, we are no closer to certainty. When the time comes for preparing tax returns, taxpayers are still scratching their heads as to whether the chosen transfer-pricing methodology or method of attributing profits to PEs will be acceptable to tax authorities. At best, in the area of transfer pricing, taxpayers prepare documentation in the hope of avoiding potential penalties. However, this is a far cry from being certain that the income reported in each jurisdiction will be accepted by the relevant tax authorities. While it is understandable that higher-tax jurisdictions wish to protect their tax base from the unreasonable stripping of profits in favour of low- or zero-tax jurisdictions, in the vast majority of situations, the application of the arm's-length principle is remarkably imprecise, giving rise to suggestions that either taxpayers or the tax authorities are taking unfair advantage of the fuzziness of the rules.

Taxpayers, by definition, need to be able to determine the tax payable in order to pay that tax. Similarly, tax authorities need to be able to determine the tax payable in order to properly administer the tax system. The needs of both parties are thus convergent. Unfortunately, it is the standard set by the arm's-length principle that creates a systemic impreciseness in its application. At its root, the arm's-length principle requires the matching of transactions or dealings entered into between non-arm's-length entities, or between a branch and the rest of an enterprise, with similar transactions that would have been entered into between arm's-length entities. In reality, in all but a few cases, this is simply not possible because the transactions or dealings of a multinational enterprise (MNE) are not comparable to those of arm's-length parties. Therefore, taxpayers, their advisers, and tax authorities are left trying to reconstruct, from largely dissimilar transactions or entities,[2] what arm's-length parties would have done in similar circumstances. As the Organisation for Economic Co-operation and Development (OECD) has emphasized, this exercise of reconstruction "is not an exact science."[3] Given the wide range of results and positions observed, one might rather conclude that it is not a science at all.

1 See articles 7 and 9 of Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, January 2003) (herein referred to as "the model convention").

2 There are numerous issues related to the comparability of transactions and entities including, for example, the use of publicly listed entities and other publicly available documents, private companies, secret comparables, or bids or other solid offers.

3 Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995) (herein referred to as "the OECD guidelines"), paragraph 1.12.

While the comments in this paper are presented in the context of the attribution of profits to PEs, they also apply to and draw from the application of the arm's-length principle in the transfer-pricing context.[4]

THE ARM'S-LENGTH PRINCIPLE: A BRIEF HISTORY

As tax authorities have struggled to preserve the integrity of their tax systems, a persistent concern since the beginning of the 20th century has been the leakage of tax revenues via operations or entities situated in low-tax jurisdictions. The concept of permanent establishment was introduced in tax treaties and in domestic tax legislation to ensure that non-resident taxpayers would pay their fair share of tax in any jurisdiction in which they carried on business through a fixed base. At first, the concept was limited to the existence of a fixed base, but it soon evolved to include other situations, such as the use of a dependent agent or the operation of a construction site.[5]

In parallel, tax authorities have tried to prevent similar attacks on their tax base via the use of foreign-based non-arm's-length companies. While these efforts have given rise to a flurry of activity, particularly over the past decade (new rules, new methods, contemporaneous documentation requirements, penalties, advance pricing agreements, etc.), early rules and cases date from the 1930s.

Another concern of tax authorities has been to maintain a level playing field with respect to the use of a branch or a subsidiary to carry on business in a given jurisdiction. It only makes sense to apply the same principle in both situations, and the arm's-length principle was selected.

The OECD transfer-pricing guidelines, released in their revised format in 1995,[6] were the culmination of efforts by the international tax community to review the existing standard and adapt it to the realities of the modern business world. The OECD guidelines reaffirmed the use of the arm's-length principle and elaborated upon its application. The original adoption of the arm's-length principle can be traced back to the earliest income tax treaties. Later, its use was formally endorsed

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4 In a short paper such as this, it is impossible to properly condense, without risking the loss of some very important distinctions and clarifications, the intricacies associated with applying the arm's-length principle. Some of the themes touched on in this paper are discussed much more thoroughly in two seminal articles—Brian E. Lebowitz, "Transfer Pricing and the End of International Taxation" (1999) vol. 19, no. 13 *Tax Notes International* 1207-10; and Michael C. Durst and Robert E. Culbertson, "Clearing Away the Sand: Retrospective and Prospective Documentation in Transfer Pricing Today" (2003) vol. 57, no. 1 *Tax Law Review* 37-135. In my view, anyone seriously considering the policy underlying the arm's-length principle should read these excellent articles. They provide both critical analysis of the arm's-length principle and historical background (some of which I have gratefully borrowed for this paper).

5 Some authors have proposed an even more expansive concept of PEs. See, for instance, Arthur J. Cockfield, "Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test" (2004) vol. 33, no. 7 *Tax Notes International* 643-54.

6 Supra note 3.

by the OECD both in article 9 of the 1977 and 1992 model tax conventions[7] and in the 1979 report on transfer pricing and MNEs.[8]

The OECD guidelines recognize the international tax community's clear selection of the arm's-length principle as the standard applicable to transfer-pricing transactions in preference to other approaches. The guidelines make specific reference to, and reject the use of, formulary apportionment as a means of establishing transfer prices. Similarly, the provision of safe harbours is rejected because it does not respect the arm's-length principle.

OECD member countries have adopted the arm's-length principle in various forms in their domestic transfer-pricing legislation. Some have opted for specific reference to the OECD guidelines, while others, such as Canada, have enacted legislation that reflects the guidelines but does not refer to them directly.[9]

In an approach similar to the one followed for transfer pricing, the use of the arm's-length principle in the context of PEs is being reviewed by the OECD with a view to updating the commentary on article 7 of the model convention. In the discussion draft issued in August 2004, the OECD has reiterated its adherence to the arm's-length principle as the guiding standard for the determination of profits attributable to PEs.[10] The refinements and elaboration have come in the form of adaptations that are seen as necessary in order to harmonize, as closely as possible, the concepts that will apply to PEs with those used in the transfer-pricing context. For instance, the OECD has already announced its adoption of the "functionally separate entity" approach as the working hypothesis underlying the application of the arm's-length principle in a PE situation:

> The profits to be attributed to the PE are the profits that the PE would have earned at arm's length as if it were a "distinct and separate" enterprise performing the same or similar functions under the same or similar conditions.[11]

To permit the adoption of an approach similar to the functional analysis required for transfer-pricing transactions, the concept of dealings between a PE and the rest of the enterprise replaces that of transactions in a transfer-pricing setting,[12]

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7 Organisation for Economic Co-operation and Development, *Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 1977) and *Model Tax Convention on Income and on Capital* (Paris: OECD, 1992).

8 Organisation for Economic Co-operation and Development, *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979), paragraph 37.

9 Canada does refer to the OECD guidelines in paragraphs 3, 4, and 8 of *Information Circular* 87-2R, "International Transfer Pricing," September 27, 1999. However, this is not legislation, but rather an administrative pronouncement.

10 See Organisation for Economic Co-operation and Development, *Discussion Draft on the Attribution of Profits to Permanent Establishment—Part I (General Considerations)* (Paris: OECD, August 2004) (herein referred to as "the discussion draft"), paragraph 3.

11 Ibid., at paragraph 19.

12 Ibid., at paragraph 65.

and the concept of activities replaces that of functions.[13] It is also necessary to hypothesize the risks that would have been assumed by the PE, the level of free capital of the PE, and the assets and the related charge in respect of assets used by the PE. The calculation requires the recognition of notional transactions and the related deduction of notional expenses (although it should be noted that the deduction of notional expenses is not acceptable in Canada, as a result of the decision in *Cudd Pressure Control Inc. v. The Queen*).[14] In addition, in establishing the "ownership" of intangible assets, one must determine whether the PE or another entity within the MNE undertakes the key entrepreneurial risk-taking (KERT) functions. Another concept that has increased influence in the discussion draft is economic ownership.

While these refinements reflect a more sophisticated approach to the application of the arm's-length principle to PEs, they will also result in greater complexity and further uncertainty about the appropriate results, as discussed below.

SHORTCOMINGS OF THE OECD'S APPROACH

While the discussion draft attempts to provide a level playing field for both subsidiaries and branches, it adds even more complexity in an area where certainty is already lost in the mists of intricate quasi-rules. And while the reaffirmation of the arm's-length principle is welcome in the pursuit of clarification of the rules applicable to PEs, the level of complexity involved is not going to make it simpler for MNEs to carry on business via branches.

With increased complexity, the documentation requirements for PEs, which will likely mirror those applicable for transfer-pricing purposes, are expected to be more difficult to comply with. Similarly, audits by tax authorities will probably follow the same course as that currently found in transfer-pricing audits, and will be both time-consuming and quite onerous for taxpayers and tax authorities alike. Thus, even if the principles laid out in the discussion draft are adopted by tax authorities, there is no demonstration of foreseeable improvement in tax administration with respect to PEs. Furthermore, the rules proposed in the discussion draft would impose more rigorous compliance requirements, but without a corresponding gain in certainty.

Given the expectation of more complexity and less certainty, it is reasonable to ask if the arm's-length principle was and is the right solution. While one could fill many pages reviewing the pros and cons of the arm's-length principle, it seems

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13 Ibid., at paragraph 72.

14 [1995] 2 CTC 2382 (TCC); aff'd. [1999] 1 CTC 1 (FCA). Since a discussion of the *Cudd Pressure Control* decision is beyond the scope of this paper, I will simply observe that the decision not only goes against the principles now laid out in the discussion draft (and arguably against the very wording of article 7 of the model convention), but it is also nonsensical in both its approach and its conclusion. The Canada Revenue Agency has attempted—unconvincingly—to distinguish *Cudd Pressure Control* in order to reconcile its approach and result with Canada's foreign tax credit mechanism (CRA document no. 2000-0001017, January 11, 2001). Evidently, it will be necessary to clarify Canada's tax rules in this area.

that, in practice,[15] it is here to stay. Thus, instead of embarking upon an exercise that might be intellectually stimulating but a practical waste of time, perhaps we should focus on deficiencies in the application of the arm's-length principle and on the objectives toward which further refinements should be directed.

One of the intrinsic flaws in the current application of the arm's-length principle is that it disregards the fact that the activities of MNEs are integrated in order to generate greater efficiencies and to provide a competitive advantage. In certain cases, the business carried on in an entire industry is undertaken principally or exclusively by MNEs. By forcing the setting of terms and conditions with respect to dealings and transactions within MNEs on a par with the terms and conditions that arm's-length parties would have agreed to in similar circumstances, the arm's-length principle is arguably contemplating phantom profits; in other words, if the profits of both parties to an arm's-length transaction are added together, the total may be higher or lower than the aggregate profit derived from a similar transaction within an MNE. This is particularly true where the dealings or transactions undertaken by an MNE do not have true counterparts in arm's-length settings.

A related issue is that, in many circumstances involving the application of the arm's-length principle, in testing whether that principle has been respected, only one side of the dealing or transaction is considered. In transfer pricing, this involves identifying the party with the least complex functions, risks, and assets ("the tested party") and determining whether the profits attributable to that party are comparable to those that an arm's-length party would have earned in similar circumstances. Again, perhaps by virtue of the widespread lack of comparability between the tested party and arm's-length entities, the tested party may be allocated more or less than its fair share of the profits, even though those profits may be in line with the range of profits of so-called comparable arm's-length parties.

AN ALTERNATIVE SOLUTION: FORMULA-BASED GLOBAL PROFIT SPLIT

Turning to the objectives of further refinement of the arm's-length principle, a method of application that produced greater certainty in its results would be easier for tax authorities to administer and less costly for MNEs to comply with.

One solution that could achieve greater certainty and also eliminate the risk of phantom profits is the systematic use of global profit splits.[16] The theory underpinning

15 Perhaps chiefly because of the OECD's reaffirmation of its commitment to the arm's-length principle, and the legislative and administrative resources committed to it by all tax jurisdictions involved, as well as the substantial resources and business structures put in place by MNEs to abide by its terms, the arm's-length principle is unlikely to be replaced in the near future—unless, of course, as some cynical observers might contemplate, the United States should decide that it is no longer the appropriate yardstick by which to measure dealings and transactions within an MNE.

16 I must confess that, when I began considering this topic, I started with the proposition that the global profit split formula should be applied only when the comparable uncontrolled price

this concept corresponds to the reasoning underlying the arm's-length principle as found in the OECD guidelines and the discussion draft. In essence, the application of the arm's-length principle necessitates the performance of a functional analysis. Arguably, if the functional analysis is performed for every component of an MNE, this should lead to the determination of an acceptable level of profit for each component. This global profit split approach should therefore ensure that no more and no less than the actual profit earned by the MNE is divided among its constituent parts.

To push the idea further, it should be possible to elaborate a profit allocation formula, using the same criteria typically considered in performing a functional analysis for transfer-pricing purposes, in order to arrive at a more objective result. In other words, although there would be some elements of arbitrariness in the approach, tax authorities should consider predetermining the evaluation and computation of, and the weight to be given to, various elements of functions performed, risks assumed, and assets used in each jurisdiction in order to determine the profits attributable to that jurisdiction.

Is arbitrariness unacceptable? Perhaps the question should be phrased differently: Is the arbitrariness of a predetermined formula any less acceptable than the arbitrariness of a post facto determination by tax authorities based on the application of the arm's-length principle? There is already arbitrariness and subjectivity in the administration of the arm's-length principle. If anything should be found to be unacceptable, it is the fact that the principle is applied on a case-by-case basis, denying taxpayers consistency of treatment. At least the predetermined formula has two distinct advantages: providing taxpayers with certainty at the time of filing their tax returns with respect to the share of global profits attributable to each jurisdiction, and simplifying the audit of transactions.

For the global profit split method to function properly, tax authorities around the world would have to agree to a common measurement of profits and common criteria for allocating those profits. While some would say that such an agreement is highly improbable because of differences in domestic tax, legal, and accounting rules, I would argue that it is nonetheless feasible. If we look back at the fracas caused at the OECD in the early 1990s by the US proposal to use profit-based methods in the application of the arm's-length principle and to establish transfer-pricing penalties, and if we contemplate the ensuing elaborate high-wire act that resulted in the adoption of the transactional net margin method in the OECD guidelines, we can see that the OECD is well equipped to resolve this type of issue. Furthermore, given the extensive experience with respect to the arm's-length principle now

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(CUP) method is not applicable. However, upon further reflection, I came to the conclusion that such a restriction would perpetuate some of the issues that currently plague the application of the arm's-length principle. Specifically, it would create an imbalance in the application of the arm's-length principle, and it may shift the focus of some taxpayers and tax authorities to attempts to use bad CUPs, secret comparables, etc. For the sake of certainty and ease of administration, this result would not be acceptable.

accumulated by the tax authorities of OECD member countries, consensus on the key value drivers in any situation should be achievable.

The systematic application of global profit split by the use of a uniform formula can be seen as a natural extension of the existing framework: already tax authorities often resort to profit splits in situations where more than one party owns intangibles, or in order to ascertain that the level of profits is shared fairly among the parties. In Canada, the residual profit split method is arguably touted by the Canada Revenue Agency as the second preference in the natural hierarchy of methods considered acceptable for transfer-pricing purposes.[17]

Is there a risk of sacrificing the level playing field between MNEs and arm's-length parties as a result of the adoption of a formula-based global profit split method? One might rather ask whether there currently is a level playing field, given the very small number of cases in which one can find truly comparable transactions or entities. MNEs are often compared not with their competitors, but with other entities carrying on business in other industries, other markets, etc. Indeed, arguably MNEs are now at a disadvantage because they have to abide by extensive compliance requirements and face potential penalties—conditions that arm's-length parties undertaking similar transactions do not face.

A formula-based global profit split method applicable in all jurisdictions and to all situations, including both transfer pricing and the attribution of profits to PEs, would arguably provide the following benefits:

- substantial savings in compliance and tax administration costs;
- the elimination of double taxation, not by negotiation but by system;
- guaranteed parity of treatment between branches and subsidiaries, and between similarly situated taxpayers; and
- the elimination of the need for various other international tax regimes, such as withholding taxes, foreign tax credits, and controlled foreign corporation provisions.[18]

Then again, tax advisers who are reading this paper would probably be forced into early retirement as a result of the changes suggested here. Imagine that.

17 See IC 87-2R, supra note 9, at paragraphs 60, 94, 105, and 145.

18 These tax regimes would no longer be needed because all of the profits attributable to a given jurisdiction would be taxed on a year-by-year basis in that jurisdiction as a result of the systematic use of global residual profit splits. Thus, rules meant to deal with the deferral of recognition of income associated with passive income or with the payment in advance of an approximate amount would no longer be required in an international context.