Rethinking the Source of the Arm's Length Transfer Pricing Problem

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The Arm’s Length Deadlock

The deadlock results from two problems:

1. The arm's length standard (ALS) is inapt for sourcing multinational enterprises’ (MNEs) income, especially with respect to intangibles- and debt-related transactions.

2. It is unlikely that tax authorities will explicitly depart from the ALS any time soon.

Presentation's Objectives

- First, to offer a proposal that focuses on reducing MNEs' ability to utilize their *financial structure* to shift income.

- Second, to change the paradigm:
  - The source of the income-shifting problem is *not debt*.
  - Instead, the problem is *control equity holdings,* which are *antithetical to the notion of ALS.*

- Third, to find a *better* solution within the ALS framework (that does not require a shift to formulary solutions).

Methodology

- Conceptual/verbal economic logic.
- Operating Assumptions (conceptual level):
  – If you cannot beat them, join them.
  – If you cannot join them, beat them.
- Operating Assumptions (practical level):
  – At least in the short run, there is a need to apply the ALS
  – But tax authorities should be able to do so in a way that is more accurate, consistent, and difficult-to-manipulate.

Problems with the ALS

- Income shifting and tax competition for reported income result in tremendous negative distributional efficiency and revenue effects.

- The difficulty with allocating MNEs' income is *the tail that wags the dog* of many complex international tax arrangements.
  - For example:
    - CFC legislation
    - deductible expense allocations
    - adopting a Territorial tax regime (U.S.)
  - All arrangements are, to a large extent, driven by the difficulties of using the ALS to source income.

Why and when should tax authorities use the ALS?

- When market comparables exist, the ALS provides a useful and difficult to manipulate *proxy.*
  - The ALS pricing of related transactions *does not necessarily reflect on MNEs' actual sources of profitability*.
  - Hence, rather than offering a correct benchmark, the ALS operates as a *reasonable* <u>*presumptive tax*</u>.

- As a presumptive tax based on a visible and difficult-to-manipulate market price, the ALS:
  - reduces taxpayers' tax elasticity
  - provides taxpayers with incentives to invest efficiently

The ALS's Arbitrariness as a Benefit

- The motivation to adopt the ALS is result driven.
  - Tax authorities use it because its *arbitrariness is useful.*
  - They do not use it because of any *inherent correctness*.

- Traditional transfer pricing scholarship finds that the problem with the ALS is the lack of a good market-price signal:
  - intangibles-related transactions
  - financial transactions capital structure (namely, the level of indebtedness)

The Price for Capital Paradox

- Tax authorities can (relatively) accurately and cheaply determine the interest rate for different types of debt instruments.****

- *If that is the case, why should financial transactions and indebtedness pose a problem under an ALS framework?*

- Answer:
  - The price for capital can be determined by ALS tools,
  - *<u>But the form</u> of capital investment is beyond the scope of the ALS analysis*.

**** Arguing against this point amounts to a tax-nihilist critique that undermines the current proposal *<u>and everything tax authorities have ever done</u> in the transfer pricing context.*

The Non-ALS Character of Equity

- More specifically, *<u>control equity investments</u>* (primarily in private corporations) *<u>cannot be analyzed via ALS</u>*.
  - In private corporations, dividends are *<u>discretionary payments</u>*.
  - *<u>Unrelated parties do not rely on discretionary payments</u>* from their counterparties.

- In the case of equity tax authorities cannot determine the ALS pricing of *<u>inherently related</u>* transactions.

If not equity, what is it? (Long-Term Subordinated) Debt

- Fitting the control equity transactions into the ALS framework requires re-characterization.

- If it is not equity (for tax purposes), it should be viewed as:
  - capital provided for a long period of time
  - lacking collateral
  - last in line in case of bankruptcy

- In other words, it should be viewed and priced as <u>long-term subordinated debt</u>, which pays (imputed)- interest rates.

Should all equity be recharacterized?

- Recharacterization should apply *only for tax purposes*. This classification should not (necessarily) have any effect on non-tax considerations.

- This recharacterization should take place with private companies where MNEs have significant holdings/voting-rights (range of 10–20%) in a subsidiary.

Public corporations

- This recharacterization should not effect public corporations because public corporations have a commitment to an explicit dividend policy to non-control shareholders.

- Policymakers may consider re-characterization if the MNE has complete control in a publicly-traded subsidiary.

The Consequence of Equity Recharacterization into Debt

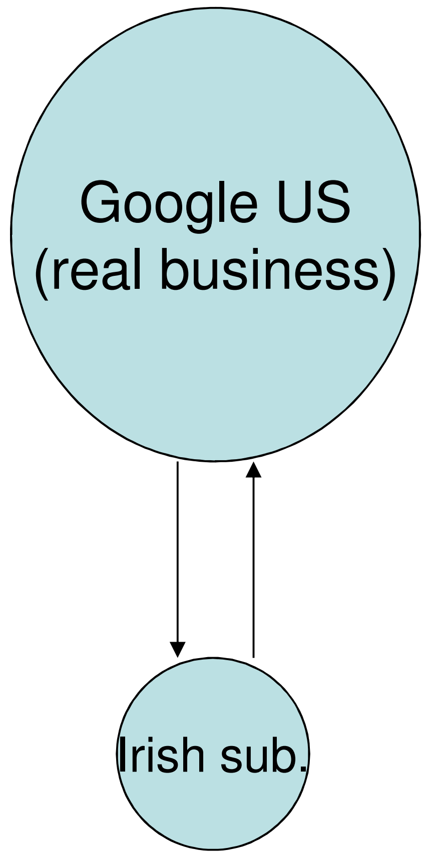
- The presentation focuses on one example (out of three in the paper): The Google/Apple double-tax sandwich.

- This is a complicated transaction that is based upon:
  - check-the-box planning
  - tax havens
  - clever treaty shopping
  - two ALS-related problems
    - Intangibles →cost-sharing agreements to migrate intangibles to low-tax jurisdictions
    - financial structure →the ability to use equity capital

The Transaction: There is nothing there!

- Step #1: Google US has valuable intangibles.

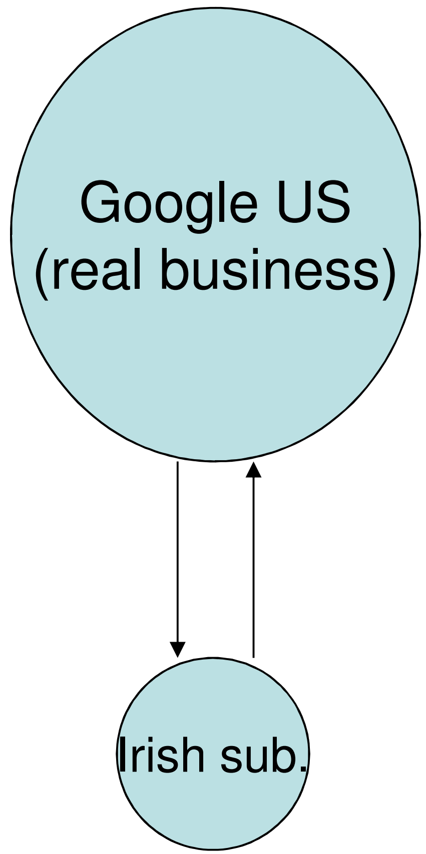
- Step #2: By the stroke of the pen, Google US…
  1. establishes Irish sub.
  2. capitalizes it with equity
  3. “buys” shares in the intangibles created by Google US



Really, by the stroke of a pen!

- Step #2 is just the shuffling of money making a round trip
  1. establishes Irish sub.
  2. capitalizes it with equity
  3. "buys" share in the intangibles created by Google US

– One minute you don't see it, the next you do…



A Double Irish Under the Proposal's (debt-instead-of-equity) ALS Analysis

- ALS analysis requires unrelatedness and therefore recharacterization.

- Instead of making an equity investment, Google US would be seen as lending the money to its Irish sub.
  - It is lending long-term subordinated debt to a high-tech corporation with no assets or cash flow.
  - The Irish sub. should be viewed as paying high, imputed junk-bond interest rates to its parent.

- The large interest spread between Google US and its subsidiary reflects the real value added by the parent.

Better (but far from perfect)

- The proposal did not solve all the problems—namely, those associated with ALS allocation of income generated by intangible assets.

- It did, however, make income shifting considerably more difficult.
  - The Irish sub. would be seen as receiving the income generated from the intangibles.
  - But it would be seen as paying high, imputed interest payments on a regular basis.
  - And, for tax purposes, it would also be seen as <u>serving a significant amount of high-yield debt</u>.

Applies to All System/Acronyms

- The proposal is concerned with allocating MNEs taxable incomes in a cheap, consistent, and transparent way.

- It is silent about how to tax foreign earnings.
  - If there are returns above the imputed rate, they could be:
    - taxed at home country rates with credits for foreign taxes (CEN)
    - exempted (CIN, CON)
    - taxed at lower rates with deductions for foreign taxes (Shaviro NTJ, 2011)

  - The same can be said about the imputed interest payments themselves.

Advantages I

- Easy to Administer:
  - tax authorities can price debt fairly well
  - reduces income shifting manipulation by MNEs
- Political Economy:
  - could be done within the ALS's analytical framework
  - in many countries may not require any change in legislation
  - with the blessing of major OECD countries and major emerging economies, could also be achieved without huge retaliation turbulences

Advantages II

- Reduces compliance and administrative costs.
  - Reduces costs directly because it simplifies the analysis of MNEs' related financial transactions
  - Also takes some of the weight off other types of complex arrangements in international taxation:
    - CFC rules
    - interest-allocation rules
    - profit methods & cost sharing for intangibles

- Allows more flexibility in forming tax policy by helping to distinguish tax competition for reported income from tax competition for investments.

Unresolved Issues

- definition of subsidiary v. permanent establishment
- sourcing income generated from intangible assets
- transitional problems
- application of thin capitalization rules

Conclusions

- Thinking outside the box.

- Applying the ALS more rigorously with respect to equity investments can provide an *incremental, yet significant, improvement*.