Arm's Length: beyond the Guidelines of the OECD

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I. INTRODUCTION: THE ORIGINAL INTENT OF TRANSFER PRICING LEGISLATION 1

Why do States enact transfer pricing legislation? While originally conceived as an anti-avoidance mechanism, transfer pricing and related debates have gradually moved towards an issue about the taxation of the “fair share” on profits derived from Multinational Enterprises (“MNEs”), irrespective of any concern based on the actual income derived from an activity subject to a State’s jurisdiction. Anti-avoidance legislation is fundamentally connected to the very concept of ability-to-pay¹, i.e., the share each taxpayer should support within a given community. In this

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sense, income is generally viewed as a reliable proxy to determine the ability-to-pay therefore legitimating States to enact income tax, including taxes on profits derived from corporations. Under this perspective, anti-avoidance legislation does not have a legitimation “per se”, but is rather conceived as a tool to make sure that the actual income is captured and taxed. One should remember Klaus Vogel’s classification\(^2\), according to which every tax rule, whilst always having the function of collecting taxes (“Ertragsfunktion”), may also have three other functions, which are not always present simultaneously, namely: i) to allocate the tax burden among taxpayers (“Lastenausteilungsfunktion”), which implies distributing the financial needs of the State according to distributive justice criteria; ii) to induct a behavior of the taxpayer; (“Lenkungsfunktion”) iii) to simplify the tax system (“Vereinfachungsfunktion”). Anti-avoidance rules should be included in the tax burden allocation function.

The anti-avoidance perspective was clearly the original intent of transfer pricing legislation. Transfer pricing manipulation has been said to be “one of the simplest ways to avoid taxation”\(^3\) and “one of the most common techniques of tax avoidance”\(^4\). In intrafirm transactions, where multinational enterprises are not restrained by market forces to set the transfer prices, there is the concern that such “power may be used abusively”\(^5\). Originally, transfer pricing rules were solely designed to exclude from the tax system a distortion engendered by common control in the definition of the taxable income. Considering this context, transfer pricing rules have been regarded as “a necessary component of any international income tax law” as this legislation would “stop MNEs from easily avoiding or significantly reducing taxation by shifting profits to low or no tax jurisdictions”\(^6\). These narratives often consider transfer pricing as an “important tool in the taxpayers’ arsenal for shifting income to low- or no-tax countries” in a sense that transfer pricing is deemed liable to a great extent for the phenomenon of “stateless or homeless income”\(^7\). In this sense, transfer pricing rules would be “meant to prevent abusive or otherwise misleading contractual terms between the involved companies”\(^8\).

The approach according to which transfer pricing rules are designed within the intent of combating tax avoidance (thus permitting the fair allocation of tax burden among taxpayers) dates back from the very origins of transfer pricing legislation. In the US, as per the War Revenue Act of 1917, the Commissioner had the authority to require consolidated returns from related corporations if this measure were necessary for a more

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equitable determination of the invested capital or of the taxable income. This legislation, as well as the following provisions of the Revenue Act of 1921, was designed, to a great extent, due to “tax avoidance opportunities afforded by possessions corporations”, being “the problem of international tax avoidance through related corporations” considered “one of the original motives” for the enactment of such rules. It is often argued that the reason behind the enactment of transfer pricing was “the fear that profits would be moved to lower tax jurisdictions”. In 1918, similar provisions were enacted in the UK within the very same intent.

Curiously enough, it is currently observed a concern among international organizations and scholars as to distinguish transfer pricing from anti-avoidance legislation. The OECD Guidelines asserts that “the consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes”. Likewise, the UN Practical Manual considers that transfer pricing “does not necessarily involve tax avoidance, as the need to set such prices is a normal aspect of how MNEs must operate”. Accordingly, in case the pricing does not accord with “internationally applicable norms or with the arm’s length principle under domestic law”, tax administrations may consider it as “mis-pricing”, “incorrect pricing”, “unjustified pricing” or “non-arm’s length pricing” and issues of tax avoidance and evasion may potentially arise. As stated by Professor Leif Mutén in the very first Klaus Vogel Lecture, back in 2007, “it would be naïve to wish for a restoration of the good old days when transfer prices were attacked only in cases of blatant tax evasion”.

Hence, if transfer pricing legislation has been enacted fundamentally as anti-avoidance legislation, this qualification has been blurred. This movement can be noted when one considers some of the main alternatives to the current transfer pricing regime, which operate as proposals for general reforms on international income taxation.

According to Klaus Vogel, distributive justice (austeilende Gerechtigkeit) can be seen under two perspectives: distribution of tax revenues among the states Verteilung des Steueraufkommens unter den beteilgten Staaten) and distribution of tax burden among taxpayers (Verteilung der Lasten auf die Gesamtheit der Steuerpflichtigen). Under this perspective, one can note that discussions concerning transfer pricing have moved from the fair taxation of a taxpayer within a given community (ability-to-pay principle), to the allocation of tax revenues among states.

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9 See, on the development of transfer pricing legislation in the U.S., R. S. Avi-Yonah, The Rise and Fall of Arm’s Length, supra n. 3, at 3.
10 R. S. Avi-Yonah, The Rise and Fall of Arm’s Length, supra n. 3, at 3.
13 OECD Guidelines, at 31, para 1.2.
14 UN Practical Manual, at 2, para. 1.1.7.
15 Id., Ibid.
If one considers, for instance, the Formulary Apportionment, it is clear that no attention is paid to the effective income of a given taxpayer, when compared to other taxpayers within the same community. The mere fact that formulae suggest an entity approach turns impossible the comparison of MNE with global presence and single taxpayers acting locally. The ability-to-pay principle is based on the comparison of comparables, which is certainly not the case when one takes into consideration income derived in different jurisdictions, under diverse conditions. As will be demonstrated below, similar conclusions may be reached when one notes the distortion on the conception of the principle of ability-to-pay (“Real Universal Taxation System”), or even taking the discussion on the ability-to-pay as irrelevant, in a mostly skeptical approach towards the issue (“Hybrid Solutions”).

In any case, it seems clear that the original intent of transfer pricing legislation has been left behind in recent discussions. Even the debates which take the current regime for granted express serious preoccupation with how transfer pricing rules would interact with General Anti-Avoidance Rules (“GAARs”) and Special Anti-Avoidance Rules (“SAARs”)18, apparently not taking into account that transfer pricing itself would originally have been designed to combat tax avoidance.

The analysis of the original intent of transfer pricing legislation shows that it has been designed to combat tax avoidance derived from transactions carried out under common control, as means of implementing the equality among taxpayers. Based on this assumption, section II of this article draws on the development of the arm’s length standard, which is still the best method to accomplish such intent. This part establishes the premises with regard to the origins and rationale of the arm’s length and proposes a classification of the critics to the method.

Section III of the article includes a brief description of the main alternative proposals to the current international consensus, in order to conclude in section IV that transfer pricing debates have essentially become the battleground for much broader proposals for reform of international tax regimes adopted around the Globe. This part is not intended to describe these propositions in detail, but is aimed at showing how transfer pricing debates have shifted from a discussion on the best form to determine the taxpayers’ taxable income to a struggle between States concerning the allocation of tax revenues. In summary, it becomes clear that the alternative proposals would require establishing new standards on taxation of income, challenging the concept of entity as a basic unit for determining the ability-to-pay in business income.

The author then offers a framework for advancing in the application of transfer pricing legislation without deviating from its original intent, i.e., privileging the principle of ability-to-pay. This article enthrones equality and regards standardization as a solution to the feasibility problems of transfer pricing legislation, also taking into consideration the compatibility between the method proposed (the “Rebutable Fixed Margins Method”) and the OECD Model Convention.

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18 This has become a frequent issue on the discussions of the BEPS drafts. See, e.g. OECD (2015), Comments Received on Public Discussion Draft: BEPS Actions 8, 9 And 10: Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, And Special Measures), dated February 10th, 2015, at 512 and passim.
Finally, emphasizing the original intent of transfer pricing legislation, the article presents critics to recent BEPS proposals with respect to adjustments as to include synergy rents, as well as to the determination of transfer pricing in cases concerning intangibles. In this context, this article points out that such BEPS proposals have as an outcome an allocation of tax revenues which significantly deviates from the determination of transfer pricing with basis on what unrelated parties would have done, as set forth in the OECD Model Convention. Such statement leads to the conclusion that the legitimacy of the OECD Guidelines is currently being undermined by the aggressive ambulatory interpretation presented in the BEPS Project in the transfer pricing actions.

II. THE ARM’S LENGTH STANDARD

The Arm’s Length Standard (“ALS”) has been said to be “the heart, spirit and the foundation of the current international transfer pricing regime”\(^{19}\). It is also a natural outcome of a system grounded in the separate entity approach for determining taxable income, as well as on the principle of the ability-to-pay. Unlike valuation methods, such as the Fair Value, which are designed to “inform readers of financial statements about the value of booked assets and liabilities”, the ALS is used for taxation purposes and is also regarded to be “intended to prevent income shifting, tax base erosion and double taxation”\(^{20}\).

II.1. The origins of the ALS

The Arm’s-Length Standard (“ALS”) has its origins in the studies of Mitchell Carroll, which focused on branches, instead of subsidiaries\(^{21}\).

When investigating the economic allegiance between origin and domicile, the Four Economists concluded that, ideally, all corporeal wealth, including immovables and tangible movables, except for money, jewelry, furniture, etc., should be allocated predominantly or wholly to the place of origin, whereas all intangible wealth, except for mortgages, should be assigned to the domicile or residence\(^{22}\). They recognized that the exact allocation would be “well-nigh impossible” and “savour too much of the arbitrary”, but suggested that “a certain rough justice” could be reached by allocating all categories of the first division to the place of origin and all of the second to the place of domicile. According to this logic, “[w]hat each country would lose in the one case it would roughly gain in the other, and there would be the great additional advantage of comparative simplicity”\(^{23}\). It is obvious that this conclusion was based on the idea that flows among jurisdictions would be balanced. This is clearly the original failure of this study, which did not consider economic differences among countries implying unilateral flows of investments (and income) thus turning distortions permanent. Due to the

\(^{19}\) Y. Brauner, Value in the Eye of the Beholder, supra n. 6, at 96.


\(^{23}\) Id., Ibid.
erroneous belief that distortions would be balanced, the very fundamental issue of fairness on the allocation of tax revenues among states was simply disregarded.

The report further recognizes that, with respect to the allocation of tax revenues, “it is not possible on the grounds of pure economic theory to indicate what proportions should actually be adopted”, insinuating the limitations of the economic allegiance. Hence, it suggests that “the proportion presenting a true compromise for country A and the rest of the world may be adopted which is inappropriate for the relations of country B to the rest of the world”.25

The reference to the Four Economists Report is important because it clarifies that the choice of the ALS was made in a context where even the grounds for a generally accepted allocation of taxing rights were not clear in the international debate, especially taking into account that the solution proposed for the division of income among source and residence was not based on an economic reason (economic allegiance) but rather on a practical solution where imbalances were foreseen and expected to be corrected through an (hardly verifiable) equilibrium of investment flows among countries. Not surprisingly, in 1928, the representatives of the several tax administrations in the ambit of the League of Nations did not reach a consensus on the allocation of profits of the units of an enterprise among countries. Indeed, there is still no international consensus on the content of ALS, or on the rules or methods which would make a transaction to be considered at arm’s length.26

After the enactment of the 1928 Model, the Committee prepared a questionnaire, the answers of which were further submitted to Mitchell Carroll, who wrote the well-known Carroll Report. The choice of the separate accounting theory in the detriment of the formulary apportionment theory is generally claimed to have been made due to practical reasons, rather than to the conviction of its author: the separate accounting theory was more frequent among the countries analyzed. However, one may not disregard that the Carroll report includes extensive critiques to Formulary Apportionment methods. In fact, Langbein even criticizes Carroll for conceiving “his role to be one of developing an international approach which would truncate any movement of the international community to the development, of working rules of fractional apportionment”.28

Carroll reported a lack of substantive legislation and case law referring to the allocation of income among the 27 analyzed countries. He deemed a careful study of practices generally followed by tax administrations on the allocation of income to national or foreign sources to be necessary. His report classifies three “General Methods of Allocation”, namely: i) the separate accounting method, which takes “the declaration of income supported by the accounts of the local branch, as a basis of assessment”29; ii) the fractional apportionment method, as per “the determination of the income of one

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24 The Four Economists Report, supra n. 22, at 4050.
25 Id., ibid.
26 J. Wittendorff, The Arm’s-Length Principle and Fair Value, supra n. 20, at 238.
27 “The adoption of separate accounting as the primary method of allocating income to the various countries in which an enterprise has permanent establishments is preferred by the great majority of Governments, and business enterprises represented in the International Chamber of Commerce, as well as by other authoritative groups.” (Carroll Report, supra n. 211, at 189.)
29 Carroll Report, supra n. 211, at 87.
establishment of an enterprise” to be carried out by “dividing total net income in the ratio of certain factors – for example, assets, turnover, payroll or a fixed percentage”; and iii) other empirical methods, which were frequently used when the tax administration considered the declaration of income according to the separate accounting method insufficient or false.  

Even though transfer pricing rules had been enacted for some time, there were no statutory benchmarks for determining the allocation of income, which would only be introduced in the 1930s. It may not be deemed as a coincidence that the enactment of such benchmarks in the US context was carried out after the Carroll Report. The ALS was present in a 1935 US regulation on transfer pricing, whereby “the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.” Avi-Yonah reports that the methods to pursue such standard were not established until 1968. The lack of methods led to the increasing importance of case law on the solution of transfer pricing issues, but courts were unable to provide the taxpayer with certainty and coherence on the application of the ALS, due to the use of multiple standards for the determination of the taxable income. This was a first hint of the problems of letting to ex post adjudication the solutions on transfer pricing criteria.

The 1968 US Regulations, applicable solely to associated companies, and not to branches, introduced the comparable uncontrolled price (“CUP”), cost-plus and resale price (“RPM”) methods. The 1968 Regulations set forth rules regarding intangibles and services, despite not including satisfactory guidance with respect to the application of the methods to these items. Even though, such regulations inspired the 1979 OECD report on transfer pricing and multinational enterprises and are of major importance for understanding the development of the application of the ALS.

The 1968 US Regulations did not include specifically the use of Profit Split Method (“PSM”) as to determine the arm’s length price of a transaction, but the use of a forth method was allowed if “clearly more appropriate” considering the facts of the case.

The PSM is commonly applicable when there is a high level of integration in the commercial operations of two or more controlled entities, which turns impractical to measure their dealings separately. PSM may also be applied when the use of the three traditional methods is not possible due to the lack of comparables. The examples of cases in which these situations may occur are many. Where the parties under common control are engaged in global trading or global development activities, or if the transactions concern licensing over use of unique intangibles, the transactions could be compared with the arrangements that would be carried out by independent parties, with regard to the division of the earnings derived in the business. Hence “simulating the

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30 Carroll Report, supra n. 211, at 46.
32 R. S. Avi-Yonah, The Rise and Fall of Arm’s Length, supra n. 3, at. 3.
33 Y. Brauner, Value in the Eye of the Beholder, supra n. 6, at. 96.
34 OECD, Committee on Fiscal Affairs, Transfer Pricing and Multinational Enterprises (Paris: OECD, 1979).
profit split” which would have been agreed by independent parties “lies at the heart of the PSM”, in a sense that the PSM could be regarded as a “combination of both the direct and indirect methods of income allocation”37. As summarized in the OECD Guidelines, “the assumption is that independent parties would have split the combined profits in proportion to the value of their respective contributions to the generation of profit in the transaction”38.

An important distinction between PSM and the other traditional transaction methods is that the former relies on net income, while the traditional methods take gross margins into account.

The PSM should not be confused with formulary allocation of income. As per the PSM, only the combined operating profit or loss from certain controlled transactions is allocated between the parties and not the earnings of the MNE as a whole. Additionally, the PSM is intended to mimic the allocation of profits that would be observed in a relation between independent parties, if a comparable contribution to the success of the activity would occur. This statement is enough to conclude that the PSM aims at being an ALS-based method.

However, several are the cases in which the solution to transfer pricing issues can hardly be considered as an ALS-based solution. An example mentioned by Avi-Yonah39 is the French case, which concerned a royalties contract signed by modest amounts for a period of 21 years. By the time of the agreement, the product still had no wide market penetration and its high profitability was not yet evidenced. According to Avi-Yonah, this case would evidence that not always the ALS should be invoked. Given that the outcomes were clearly disproportionate to the expectations of the parties when the contract was signed, the tax authority was forced to challenge the application of the ALS, of which it had been the main supporter until then. The Court did not accept the new tax authority’s position. This reasoning was maintained until the Reform of 1986. Avi-Yonah also mentions the U.S. Steel Corp. case, in which US tax authority did not comply with the freight paid to a related enterprise, even in the case that the value did not differ from that charged from unrelated parties. The tax authority claimed that the were different situations because the quantities traded were very different, as well as the conditions of the transactions (guarantees, etc.). Notwithstanding, the Court kept the application of the ALS, which had been strongly enforced in the past by tax authorities.

In such circumstances, it is interesting to note the developments that occurred in the United States, narrated by Avi-Yonah. The author shows that, even though the precedents mentioned earlier were sufficient to point out the distortions of unrestricted application of the ALS, there was great hesitation as to which alternative criterion should be adopted. From new cases, alternative paths arose that were no longer based strictly on comparisons. An example is Cadillac Textiles v. Commissioner, when the Court, after denying comparisons proposals, ended up adding the profits of the parties involved, sharing them in a way similar to what would later be known as the PSM. Given the lack of regulation of the matter at that time, one must criticize the arbitrary way in which the Court made the distribution. The same appraisal was also present in other cases, e.g. E.I. Dupont de Nemours & Co v. Commissioner and Eli Lilly & Co v.

37 C. Sommers, Separate Accounting or Unitary Apportionment? (EUL Verlag, 2011), at 71.
38 OECD Guidelines, at 94, para. 2.110.
39 See R. S. Avi-Yonah, The Rise and Fall of Arm’s Length, supra n. 3.
Commissioner. In both cases the Courts resorted to an arbitrary method to allocate profits.

Faced with such hard cases, the commensurate with income clause was added up, in 1986, understood as the need to adjust the negotiated price, in face of benefits from intangibles. This provision became known, in the US practice, as super-royalty and its application demands that each year the taxpayers are subject to review and adjustments to the royalties charged, in order to ensure that they remain “commensurate” with the income that the intangible produces on the hands of the transferee. Because of the difficulties to determine the content of this clause, the Congress decided to reformulate the regulations in force since 1968, to reflect the new legal requirements. The US Treasury Department issued, on October 18th, 1988, a study on this provision (the “White Paper”). This study raised several discussions until July 1994, when the final regulations on intangibles were enacted. The legislation was complemented in December 1995 and May 1996, as to include details on cost sharing agreements. This standard demands that revenues obtained from transfer or license of intangible property are commensurate with the income attributable to that form of intangible property item. The notion underlying this provision is essentially that parties shall distribute profits according to, among other things, assets used, costs incurred, functions performed, risks assumed and intangible assets used. Yariv Brauner points in commensurability two “benefits”: (i) recognition that the pure analysis of ALS is not always required; and (ii) emphasis on the importance of the transfer of intangible assets and admission that one cannot always count on comparable assets.

Curious enough, the US Congress did not accept that commensurability was incompatible with ALS. However, even if a fully comparable transaction were found, in which the same intangible assets were transferred to an unrelated party in the same circumstances, for a fixed rate of royalties, it would require, likewise, the allocation of the super-royalty in the case of a transaction between related parties. Avi-Yonah also notes that the White Paper did not seem comfortable to leave the ALS, choosing to refer to the new requirements as Basic Arm’s Length Return Method (“BALRM”), allotting a chapter to demonstrate that commensurability and BALRM were compatible with ALS. This is difficult to follow, since, in principle, commensurability is applicable in the

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41 The following sentence was added to Section 482: “in the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B), the income with respect to such transfer or license shall be commensurate with the income attributable of the intangible”.


44 Reg. §§ 1.482-2 to -6.

45 Reg. § 1.482-7.


47 See Y. Brauner, Value in the Eye of the Beholder, supra n. 6, at 100.

situation of a lack of comparables. In other words, there was, at best, a new definition of ALS, which no longer would be the search for comparable prices, but rather, on the reconstruction of any results consistent with those that would be sought by independent parties.

Similarly to the PSM, as per the Transactional Net Margin Method (“TNMM”) the income is allocated between the entities by comparing the “net margin earned by the tested affiliate in a specific transaction to net margins obtained in comparable uncontrolled activities”\(^{49}\). In this aspect, the TNMM is similar to cost plus and RPM, and would generally not be applicable where the parties to the transaction under consideration make unique contributions. In such cases, the PSM should become applicable\(^{50}\). TNMM also entails a comparison with the transactions that would be undertaken by unrelated parties. For this purpose, the net margins in open-market transactions are measured and the calculated uncontrolled margin is subsequently applied to the operations between related parties. Therefore, the TNMM also entails an effort to be considered as an essentially ALS-based method.

In spite of the clear deviation – as from its origin – of both TNMM and PSM from ALS, it is interesting to note the effort to deny such divergence. It is often considered that the PSM, \textit{e.g.}, is applicable even in a situation where there are no “close comparables”. Even under such circumstances, however, “where there is no more direct evidence of how independent parties in comparable circumstances would have split the profit in comparable transactions”, the OECD maintains its position for the application of the PSM, being the allocation of profits “based on the division of functions (taking account of the assets used and risks assumed) between the associated enterprises themselves”\(^{51}\).

In these cases, the qualification of PSM and TNMM as ALS-based methods becomes blurred. At this point, one must question: how much fiction does the ALS tolerate? Is it possible to answer the question “how would synergy rents be allocated between independent parties?” The OECD Guidelines explicitly recognizes that “the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses”\(^{52}\). This sort of questioning and the corresponding approach of the OECD towards this issue has led to the statement that the ALS is “slowly but surely being relegated to the back seat” of the OECD Guidelines\(^{53}\).

In this context, Avi-Yonah concludes that if it is accepted the premise that ALS does not require comparison, then the ALS includes a \textit{continuum}, comprising also the FA, since even the latter can achieve similar results to those obtained by unrelated parties\(^{54}\). This conclusion does not seem obvious. To argue that the FA (or any arbitrary allocation) can achieve similar results to those that would have been reached by unrelated parties is to affirm a rule based on an eventuality. If it is true, on the one hand, that this method is based on effective data (global income), on the other hand, the formulae for their

\(^{49}\) C. Sommers, \textit{Separate Accounting or Unitary Apportionment?}, supra n. 377, at 73.
\(^{50}\) OECD Guidelines, at 77, para. 2.58.
\(^{51}\) OECD Guidelines, at 94, para. 2.110.
\(^{52}\) OECD Guidelines, at 34, para. 1.10.
\(^{54}\) See R. S. Avi-Yonah, \textit{The Rise and Fall of Arm’s Length}, supra n. 3.
allocation are obtained in such an arbitrary manner, that it would hardly fit in a ALS-based reasoning.

II.2. The Rationale of the ALS

Although the ALS has been said to provide for fairness in the distribution of tax revenues among States, its rationality should be considered as per its original intent, i.e., the need for equality between related and unrelated firms. Market prices as a tool to evaluate the adequate price of transactions would, in this approach, contemplate the neutrality that should be inherent to taxation. ALS would provide “broad parity of tax treatment for MNEs and independent enterprises”, granting more “equal footing for tax purposes”. This would avoid the creation of tax advantages that would distort the “relative competitive positions of either type of entity”.

Behind such rationale, one can find the ability-to-pay principle and, more generally, the principle of equality. The latter has been defined as “the comparative relationship that obtains between two or more distinct persons or things by virtue of their having been jointly measured by a relevant standard of comparison and found to be indistinguishable by reference to that standard”. Taxpayers carrying out a controlled transaction have sufficient power to misprice the operation, thus jeopardizing the taxation of income. This would lead to a situation where entities of a MNE are less taxed than independent parties would be, even if they make the very same transaction. Transfer pricing legislation is intended to fix this situation, thus reestablishing the equality among taxpayers by allocating income according to their ability-to-pay, irrespective of their power to influence the price of controlled transactions.

To understand the role of equality for transfer pricing legislation, one should refer to Humberto Ávila’s “theory of tax equality”. His theory is designed to offer an analytical and functional method to evaluate tax equality. According to the Brazilian Professor, the “structural elements” of equality would be i) the subjects (“sujeitos”); ii) the criterion or standard of measurement (“criteirio ou medida de comparação”); iii) the proxy (“elemento indicativo da medida de comparação”); and iv) the scope of the distinction (“finalidade da diferenciação”). In other words, equality requires taxpayers (subjects - i) comparable under a specific criterion (ii) which is measured according to a (iii) proxy chosen with a specific scope (iv) which can be the allocation of tax burden according to distributive justice criteria (ability-to-pay for taxes, costs for public fees, offense for crime penalty) or an external one (for example, behavior induction, simplification for predictability etc.).

The criterion of measurement must be grounded in reality and, more importantly, the criterion must be relevant for the scope it pursues. This is an important feature of Ávila’s theory: the equality exam is roughly speaking “scope-oriented”. The standard of

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56 OECD Guidelines, at 33, para 1.7.
58 H. Ávila, Teoria da Igualdade Tributária (2nd ed., São Paulo, Malheiros, 2009), at 42.
59 H. Ávila, Teoria da Igualdade Tributária, supra n. 58, pp. 44-45.
measurement must implement the scope of the distinction. This shows that the scope of the distinguishing logically precedes the determination of the standard of measurement.60

In tax law, the fair distribution of tax burden has generally been seen as a scope for which ability-to-pay appears as an acceptable standard of comparison among taxpayers.61 Since taxes aim at financing the common needs of a given community, all members thereof are expected to pay their shares. No one should be exempted from contributing for common expenses, but the share to be supported by each member will vary according to his/her ability-to-pay.

Since ability-to-pay is generally accepted as the criterion, as defined in Avila’s theory, one can conclude that those taxpayers within a given community having similar ability-to-pay should pay similar taxes. Equality requires, however, that taxpayers may be compared, i.e., that there must be conditions to compare taxpayers under the criterion. Profits are seen as an adequate proxy to compare taxpayers’ ability-to-pay. This is true, however, as far as companies’ profits are calculated according to the same rules. It would be unacceptable, under the ability-to-pay principle, to compare profits of two companies, if they were reflected, e.g., in different currencies. One would immediately require a conversion of one currency into the other, in order to determine which company earned more in the period. Transfer pricing legislation essentially deals with this rationale. It recognizes that while the profit reflected in the books of a company may be a good proxy to determine the ability-to-pay of a company acting in market conditions, the same is not necessarily true in case of companies trading with related parties. Numbers of the latter do not reflect income, at least not the same income which would be revealed in market conditions. In summary, profits, as a net result of all transactions of a company, are an adequate proxy to the ability-to-pay as far as the company trades in market conditions. In case such conditions are absent, profits will rather reflect (among others) bargaining power of a group entity, which will be able to force its related parties to trade under imposed conditions, which may differ from market ones. Such bargaining power has nothing to do with the ability of the entity to create income. Companies having weak bargaining positions may suffer losses which do not reflect their economic activities.

In such terms, the rationale behind the ALS is obvious: it may be claimed to be the key for converting numbers derived from transactions among related parties to transactions in market conditions. In other words, the very rationale of the transfer pricing legislation is to provide for income derived by companies trading with related parties to be measured according to the same parameter employed to determine the income of independent parties. Since the latter are taxed according to the profit derived from transactions in market conditions, transfer pricing legislation aims at converting to market profits those numbers reflecting transactions within a group. Under such perspective, one should consider that there is a reason behind the choice of the ALS, since it has been seen as an adequate key to “convert” profits of related parties into market profits, thus allowing the principle of equality to work.

60 H. Ávila, Teoria da Igualdade Tributária, supra n. 58, at 45.
While ability-to-pay is the criterion and market income is the proxy, one should keep in mind that equality also contains a subjective element: whose ability-to-pay is to be compared? This analysis is relevant to support the idea that transfer pricing legislation requires an entity approach, as opposed to a consolidated one. Accordingly, if it is true that the very target of transfer pricing legislation is to determine the market income (proxy) of an entity in order to allow the tax burden to be adequately distributed among members of a given community according to the criterion of measurement (ability-to-pay), it is immediate that even before applying any transfer pricing adjustment, one should define who is expected to be subject to taxation, i.e., who is expected to be compared and taxed equally. Comparability analysis is therefore two-fold: not only the proxy must be the same (in this case: profits earned in market conditions), but also taxpayers must be comparable. There must be a justification to elect a given taxpayer and to require taxes. Residence and source are generally seen as elements of connection enough to legitimate taxation. This explains why two companies equal under the same subjective and objective perspectives should equally share tax burden. However, if transfer pricing does not adopt an entity approach, but rather a consolidated approach, then there is a logical fail in comparison and the whole rationale of such legislation may be jeopardized. One would compare an entity acting within a country with a group of entities acting in different conditions. This is not a mere transfer pricing divergence: it goes further as to compare subjects where there is no justification for equal treatment.

Of course one could discuss the fundamental choice of taxing companies (entities), rather than groups. Furthermore, the decision whether or not to tax legal entities is not obvious and there is an interesting debate concerning the convenience of eliminating corporate taxation. However, as long as corporate taxation is entity-based, there is no justification to require the same burden to be supported by a company acting within the boarder of a given community and a group of companies connected to several jurisdictions (and therefore owing taxes to all of them). The element of connection (residence) is not the same and requiring both of them to be taxed under the same parameters would not comply with the principle of equality. In summary: if unrelated parties acting within a community are taxed according to their (individual) profits earned in market conditions, derived from their (individual) efforts, the ability-to-pay principle would (solely) require related parties to deserve equal treatment, i.e., have their individual market profits to be calculated and taxed.

In this sense, when adjusting profits with reference to the conditions that are expected to have been obtained by independent parties in comparable uncontrolled transactions, the ALS treats the members of an MNE as separate entities, not considering them as “inseparable parts of a single unified business”. As a consequence, the comparability analysis is deemed as central to the application of the ALS, in order to treat the members of the MNE group as if they were independent parties. Thus, the ALS generally entails a comparison between controlled and uncontrolled transaction, in a sense that the taxation of the entities of an MNE group is determined by what independent parties would have done.

63 OECD Guidelines, at 33, para. 1.7.
The ALS enthrones transactional neutrality, which is one of the aspects of tax neutrality. Accordingly, ALS ensures that similar economic transactions are similarly taxed, irrespective of the form used in carrying on the business. The OECD emphasizes that “in no case should transactional profit methods be used as to result in over-taxing enterprises mainly because they make profits lower than the average, or in under-taxing enterprises that make higher than average profits”. Accordingly, there would be “no justification under the arm’s length principle for imposing additional tax on enterprises that are less successful than average or, conversely, for under-taxing enterprises that are more successful than average, when the reason for their success or lack thereof is attributable to commercial factors”.

II.3. The ALS as a legal fiction; the methods as a presumption

Through legal fictions, consequences foreseen by a rule to one case are extended to other cases not originally intended by the rule. Instead of regulating new cases and determining their respective legal consequences, legislator simply declares that new cases (fingierter Tatbestand) shall be treated as previous regulated ones (Fiktionsbasis). In tax law, legal fictions are employed in order to permit different cases to be subject to the same taxation.

Under this perspective, one can easily understand the ALS as a legal fiction: considering that transactions among related parties are not within the market, transfer pricing legislation determines that said transactions shall be taxed in the same manner as comparable independent transactions would have been treated. In other words, through a legal fiction, the controlled transactions will be deemed to have been dealt according to the ALS. Instead of taking into account the actual amount paid or received by the parties in the controlled transaction, taxation will be based “as if” they had occurred on the prices according to the legal fiction, i.e., ALS prices.

Transfer pricing legislation does not only entail a legal fiction. There is also a legal presumption: while the legal fiction requires related parties to be taxed as independent parties would have been under same conditions, transfer pricing legislation also determines that there will be a legal presumption that independent parties negotiate according to methods like CUP, RPM etc. These methods, therefore, are not necessarily aimed at determining the prices that related parties actually trade, but are rather a (legal) presumption of the prices that unrelated parties would trade according to ALS.

As a matter of fact, when one considers tax law in general, one will easily agree with José Casalta Nabais, according to whom taxation is not based on the exact and rigorous appreciation of reality: accounting is itself based on several assumptions which are not expected to be evidenced, but rather agreed. The Portuguese Professor refers to Einaudi’s idea that searching a “real” profit is a “pure myth”, which only accountants

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64 J. Li, Global Profit Split: an evolutionary approach to international income allocation, 50 Canadian Tax Journal 823 (2002), at 828.
65 OECD Guidelines, at 61, para 2.7.
believe in\textsuperscript{67}. Accordingly, it is true that since it is impossible to precise the profit of one company, some concessions are necessary, otherwise taxes would not be determinable, and the very existence of the State would be in danger. Therefore, the profit of a company is calculated by means of several accounting and tax conventions, which allow one to reach a profit which is acceptable enough, but which is not scientifically verifiable. There are several examples of such conventions. Take the mere periodic calculation of profits, which imply disregarding inter-anual results. Or the depreciation of assets, calculated according to determined rates which may be verifiable in general, but which will hardly correspond to the actual duration of a concrete asset. This is enough to confirm that taxation is not based on facts, but rather on an acceptable version of facts. Lord Keynes’ quotation, “It is better to be roughly right than precisely wrong”, certainly plays an important role in this matter.

This assumption should also be taken into account when one considers the transfer pricing methods: it is certainly impossible to know how an independent party would react in a specific transaction. Methods are presumptions which try to reflect what they probably would consider. One should not expect methods to reflect reality, but to reflect the expected (generally acceptable) reality.

In the same manner – it is important to have this also clear – presumptions in tax law are always rebuttable, and the transfer pricing methods do not constitute an exception to this rule: taxpayers must be granted the right of bringing evidence contrary to the presumption.

However, if one takes into account the circumstance that taxation itself requires an acceptable version of the facts, the contradiction of a rebuttable presumption does not require the evidence of a fact, but rather convincing evidence that different circumstances should be considered.

Back to the transfer pricing methods, their contradiction does not require the parties to prove that independent parties actually deal differently; it is sufficient to argue that they would most likely determine other prices. This is not a scientifically verifiable evidence, but rather an argument strong enough to build a consensus which could be opposed to the presumption.

\textit{II.4. The Objections to the ALS}

Objections to the ALS can be classified in two different groups. On the one hand, there is a very important objection addressing the rationale of the ALS, which deserves to be considered apart from the others. Most articles, both for\textsuperscript{68} and against\textsuperscript{69} the standard,

\textsuperscript{67} See José Casalta Nabais. \textit{Por um Estado Fiscal Suportável: Estudos de Direito Fiscal}, (Coimbra, Almedina, 2005), at 374.


report there would be a conceptual flaw underlying the ALS, which could jeopardize both the determination of the taxable income and the allocation of taxing rights among States. In other words, these considerations refer to the very core of the ALS.

On the other hand, there are general objections to the feasibility of the ALS. This second category of arguments against the ALS do not consider its rationale, i.e., the principles underlying the ALS, but instead question the possibility of adopting the proceedings proposed by the method. They are generally marginal arguments not against the standard but rather concerning the methods which have been developed to reach it: they are not concerned with whether the standard is in principle fair or efficient, but rather consider that, in real world, methods are neither fair nor efficient, since they would simply not work.

At first glance, it may seem that such a classification is naïve, given that, at the end of the day, a proposal that is not feasible is also flawed in its rationale. In fact, it is valid objection to say – as opponents of the ALS generally do – that the marginal arguments addressing feasibility amount to an extent that they reach the very core of the ALS.

However, the distinction proves useful to show a pattern on the objections, according to which, as well observed by Mitchell Kane, “one sometimes begins with a statement of the critique that is supposed to point out the ‘inherent flaw’ but then this blends seamlessly into a general discussion of problematic intangibles” and other feasibility issues. Also, in the second part of this article, the author proposes solutions concerning the feasibility of the ALS, which keep the problems as marginal. Another aspect that justifies the classification is that the so-called inherent flaw will be addressed apart, within a different framework from the solutions to the feasibility issue.

II.4.1. Rationale: ALS as an inherently flawed method

Fundamentally, the transactional ALS approach is criticized for not reflecting economic reality. Accordingly, there would be “synergy rents” arising from economies of scale and integration, which the ALS would not be able to take into account. Hence, it would not be possible to soundly divide profits in an integrated firm with bases on comparability and market prices. ALS would not reflect reality, because MNEs do not treat each subsidiary as a separate entity, but rather as integrated entities, whose prices can be controlled by the MNE, considering the respective tax implications. The possibility of achieving economies of integration by the internalization of activities would, then, pose a conceptual flaw to ALS.

In these terms, ALS would fail to take into consideration the reasons why MNEs are created. Grounded in the theory of the firm, adversaries of the ALS convincingly argue that internalization allows integrated enterprises to carry out transactions more

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70 M. Kane, Transfer Pricing, Integration and Synergy Intangibles, supra n. 68, at 297.
73 R. Vann, Reflections on Business Profits and the Arm’s Length Principle, supra n. 699, at 139.
efficiently than independent enterprises, which must follow market prices. As per this reasoning, MNEs would be created “because they generate returns internally above what can be obtained in market transactions”75, and this aspect should be taken into consideration on the setting of transfer prices. MNEs would specifically choose to benefit from a certain way of structuring their business, instead of engaging in market transactions, and, as a result, trying to compare transactions carried out by independent enterprises with intracompany transactions would be “attempting to compare the incomparable”76. A good example can be seen when one considers the costs of transaction upon the signature of a supply agreement: it is reasonable to imagine that independent parties would spend hours with their legal advisors before signing an important agreement, considering the risks involved (non-payment, non-delivery etc.); the same risks would be quite remote in case of transactions within a group, thus requiring much less attention as to the terms of the supply agreement.

Also, these synergy returns would not arise from transactions carried out, but would instead be explained as “attributes of the firm”. As the ALS takes the occurrence of transactions as central for the comparability analysis, the returns arising from synergies would not be adequately evaluated by a system based on transactions77. The ALS would then demand MNEs to “report their income in a way that breaks down the cost saving associated with being a MNE”78.

The inherent flaw would give rise to a problem of allocation of the income as well. In transactions between parties under common control, there would be profits that may not be subject to allocation, either to the seller or to the buyer, since these profits can only be considered as an immediate consequence of the organizational form chosen by the enterprise. Hence, said profits are not attributable to any of the parties to the transactions, but are directly related to the synergy of the group. As Langbein sustains, the application of ALS-based methods may lead to a situation where these “residual profits” are not allocated to any of the States, as the ALS would conceptually fail to determine the jurisdiction to which these residual profits should be allocated79.

The residual profit problem clearly occurs when different ALS-based methods are applied to each of the associated enterprises. Schön describes the residual profit problem as an issue of adjusting the price of a transaction between the parent and the affiliated company considering the “slicing of the joint profit exceeding the risk-free rate of return on the sunken investment”80.

As summarized by Wittendorff81, in case the controlled transaction is evaluated under a single method, the allocation of the income will vary according to the method applied: i) the application of a one-sided method would lead to the allocation of benefits to the enterprise that is not being tested, which usually would engender the allocation to “the enterprise that makes the most significant contribution of intangibles to the controlled transaction”; ii) the use of the profit-split method would often result in the allocation in

75 R. Vann, Reflections on Business Profits and the Arm’s Length Principle, supra n. 699, at 140.
76 Y. Brauner, Value in the Eye of the Beholder, supra n. 6, at 108.
77 R. Vann, Reflections on Business Profits and the Arm’s Length Principle, supra n. 699, at 140.
80 W. Schön, International Tax Coordination for a Second-Best World (Part III), supra n. 8, at 242.
proportion to the contribution of intangibles to the transaction under analysis; and iii) the application of the CUP method would have as outcome the allocation of the synergy rents in proportion to “the benefits actually realized by the associated enterprises”. Such conclusions are clearly very generic and may be challenged on a case-by-case analysis. However, it is true that if only one country applies a method, there will be no lack of profit allocation, since the “remaining” residual profit will be taxed by the other country. Such allocation, however, has nothing to do with the effective participation of the parties in the transaction and moreover offers no explanation as to reason why the “other country” would be granted to tax all residual profit, irrespective of the fact that synergy derives, per definition, from a common effort of the parties.

Transfer pricing adjustments based on ALS are intended to promote equal treatment between taxpayers, regardless of the business framework they design to carry out their activities, whether through dependent or independent business. The ideology supporting such thought is that there would be no justification for any tax treatment affecting the make or buy alternative. The decision on whether to acquire in or outside the enterprise should be driven purely by business reasons. In this sense, “if there is a change in the business model, the tax reaction should try to adjust to the characteristics of this change”\(^82\).

However, if synergy rents exist, the ALS will not be enough to grant tax neutrality in the make or buy decision, because the market price will be distinct from the ALS price\(^83\). Hence, the fact that the ALS method does not take into account the existing synergy in an economic group is deemed by some as a necessary outcome of the method, in a sense that the ALS would be “inherently flawed”. The response of the OECD to this criticism is that there would be “no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises”\(^84\). Exactly because there is no clear measure for the allocation of the benefits arising from integration, the simplistic approach of the OECD, as to allocate the residual profit solely considering the behavior of independent parties, seemed “naïve” to Wolfgang Schön\(^85\).

According to the classification proposed, this would be the sole critic to the rationale of the ALS, i.e., the ALS fails to take into consideration the fundamental economic reason why MNEs are created and, as a result, residual profits are not adequately allocated. The other critics, as will be addressed below, are critics to the application of the standard, i.e. they do not address its rationale, but rather the feasibility of reaching it.

### II.4.2. Feasibility: difficulties in the application of the ALS

It is a fact that the current ALS-based system is “absurdly complex”\(^86\), since it burdens both taxpayers and tax authorities, with compliance and enforcement costs. The “principal weakness” of the ALS would be “its inability to control tax-motivated

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\(^{82}\) W. Schön, International Tax Coordination for a Second-Best World (Part III), supra n. 8, at 237.

\(^{83}\) J. Wittendorff, The Arm’s-Length Principle and Fair Value, supra n. 20, at 240.

\(^{84}\) OECD Guidelines, at 34, para. 1.10.

\(^{85}\) W. Schön, International Tax Coordination for a Second-Best World (Part III), supra n. 8, at 242.

\(^{86}\) R. S. Avi-Yonah; I. Benshalom, Formulary Apportionment – Myths and Prospects, supra n. 699, at 376.
transfer pricing with respect to intra-MNE shifting of income from intangibles”. Also, the ALS would be based on a supposed “fallacy” according to which “transactions among unrelated parties can be found and that they can be used as meaningful benchmarks for tax compliance and enforcement”\(^87\).

The failure of the ALS would also be evidenced by the increasing use of profit-split methods by tax authorities when no market comparables may be found\(^88\). As per this method, tax authorities would not try to figure out how unrelated parties would have priced the transaction, but would rather chose to aggregate the income generated from the transaction and split them among the subsidiaries.

Another critic that is commonly addressed is that the content of the ALS would be increasingly unknown, due to the lack of valuable case law, thus giving rise to undesirable litigation\(^89\). The absence of useful precedents could be partially attributed to the emergence of confidential Advance Pricing Agreements (“APAs”)\(^90\), but in essence, it could be considered as a natural outcome of the very nature of comparability analysis\(^91\). Decisions grounded in comparability are often too specific to allow a considerable degree of legal certainty for the taxpayer on future decisions or, in the expression used by Baistrocchi, such decisions are “unable to produce case law with public good features”\(^92\).

The OECD Guidelines, despite recognizing difficulties of the application of the ALS, considers that the experience arising from its application “has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administration”. Such experience “should be drawn on to elaborate the arm’s length principle further, to refine its operation and to improve its administration by providing clearer guidance to taxpayers and more timely examinations”\(^93\).

**III. ALTERNATIVE PROPOSALS**

**III.1. Formulary Apportionment**

The Formulary Apportionment (“FA”), also called unitary approach, recognizes the MNE group as a single economic entity, thus allocating portions of the profit of the group to each related party, with basis on a formula intended to reflect the economic contributions of each party for the generation of the profit of the group. The critics to

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\(^87\) R. S. Avi-Yonah; I. Benshalom, Formulary Apportionment – Myths and Prospects, supra n. 699, at 376.

\(^88\) R. S. Avi-Yonah; I. Benshalom, Formulary Apportionment – Myths and Prospects, supra n. 699, at 382.

\(^89\) E. Baistrocchi, The Transfer Pricing Problem: a global proposal for simplification, supra n. 5, passim.


\(^92\) E. Baistrocchi, The Transfer Pricing Problem: a global proposal for simplification, supra n. 5, at 951.

\(^93\) OECD Guidelines, at 36, para 1.15.
the ALS argue that FA would be a better method to restrain aggressive transfer pricing.\textsuperscript{94}

The justification of the FA takes as premise the alleged “inherent flaw” of the ALS as described above. Unlike ALS, FA would take into account the option of the enterprise to internalize the value chain. Consequently, a common feature of FA proposals is that they disregard intra-group transactions. This choice ends up distorting the actual relation between companies in a group context, giving rise to important economic consequences.

Under the FA, for instance, a subsidiary which renders services for the group as a whole in an extremely inefficient structure, bearing unnecessary labor costs, could be deemed to generate profits, even though the activities carried out are evidently unprofitable. Under the ALS, the group remunerates the services rendered on a market basis; if the subsidiary is not able to render the service with the same efficiency as a competitor would in the same circumstances, its profit margin will be reduced or the company may even generate losses, imitating, for tax purposes, what would happen in an independent context.

However, while adopting a formula-based approach, the efficiency within the subsidiaries of the group is irrelevant. Considering that, in the example, the inefficient company employs several workers, a positive share of the total income of the group shall be allocated to the potentially loss-generating subsidiary. It is evident that such an outcome, besides evidencing a distortion of the allocation of income, jeopardizes the very notion of what income is\textsuperscript{95} and its role as a parameter for the application of the principle of equality. Even if it is evident that the subsidiary has not profited from its activities, a portion of the taxation of profits shall be allocated to the State in which the subsidiary is located. The ability-to-pay principle is simply disregarded due to the lack of comparison between taxpayers.

A relevant problem with this option, from an international perspective, is that it directly affects the territorial allocation of profits. Mitchell Carroll regarded that “[t]he reasons for arguing that this formula is arbitrary are fairly obvious”\textsuperscript{96}.

The apportionment of the total net income of an enterprise carrying on world-wide operations means that its profits and losses will be pooled and then distributed fairly evenly, by the use of arbitrary factors, to the various countries in which it operates, and not to the actual sources of the income\textsuperscript{97}.

Some approaches supporting formula-based mechanisms instead of ALS are characterized by a strong skepticism: authors do not engage in arguing that the FA is not


\textsuperscript{95} This problem was already reported by Mitchell Carroll, who, while criticizing the adoption of FA for joint net profits, mentioned that “owing to faulty operating methods or to economic circumstances, a loss might actually be realised in one country, yet it would automatically receive a part of the profit realised in the other country”. (Carroll Report, supra n. 211, at 198.)

\textsuperscript{96} Carroll Report, supra n. 211, at 198.

\textsuperscript{97} Carroll Report, supra n. 211, at 189.
arbitrary, but merely sustain that “formulary alternatives are as arbitrary as the ALS”, expressly recognizing that FA “cannot penetrate the MNE profit-generating process”.

Such a statement shows that the argument based on the “inherent flaw” of the ALS is not sincere. Sponsors of the formula based solutions take the ability-to-pay as secondary, considering it irrelevant or impossible to determine the actual income derived by the taxpayer. The mere idea of comparing taxpayers within a community as a basis for sharing the tax burden is put aside, and practicability arguments (better: revenue interests) seem to be the sole justification for the employment of FA. Several times, this skepticism gives rise to the so-called “hybrid solutions”, whereby the ALS should remain applicable to cases where comparables are easily found and formula based solutions are proposed to the remaining cases.

III.2. Hybrid Solutions

It has already been suggested that ALS and FA should not be seen as binary and mutually exclusive alternatives. Embedded in the referred skepticism with respect to the determination of transfer pricing rules, the claim for a hybrid solution, which considers the strengths and weaknesses of each method, has been under debate in the last decade. Accordingly, a “recurrent element” of the debate would be “the attempt to find pragmatic solutions in between these opposing concepts”.

The OECD, despite the ascending use of profit-split and other methods deemed “quasi-formulary” by opponents of the ALS, does not recognize such trend. In fact, expressly referring that FA “would not be acceptable in theory, implementation, or practice”, the organization contends that “no legitimate or realistic alternative to the arm’s length principle has emerged”. The ALS allocation should be used whenever there is a “clear, easily observable, and consistently priced market benchmark”.

III.3. The “Real Universal Taxation System”

Fleming Jr., Peroni and Shay contend that MNEs should be taxed in their worldwide income, considering not only of the parent company, but also of the subsidiaries, as long as the parent company is owned by US residents. The income of the parent company and the subsidiaries should be “consolidated and subjected to a current, non-deferred U.S. income tax with a foreign tax credit system having robust limits that seriously constrain cross-crediting”. The authors regard that, in such scenario, the transfer pricing strategy of the MNEs would be far less significant, since the income shifting would not imply circumventing US taxation.

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99 See R. S. Avi-Yonah; I. Benshalom, Formulary Apportionment – Myths and Prospects, supra n. 699, at 381.
100 W. Schön, International Tax Coordination for a Second-Best World (Part III), supra n. 8, at 235.
102 OECD Guidelines, at 36, para 1.15.
103 See J. C. Fleming Jr., R. J. Peroni & S. Shay, supra n. 94.
Their proposal is very comprehensive and well structured: it takes into consideration ownership and residency issues, includes solutions addressing runaway corporations, and is, in fact, well designed to pursue the policy objectives contended by the authors. It is not within the scope of this article to describe the details of the proposal, but there are some policy considerations underlying the system that should be addressed.

According to the authors, the Real Universal Taxation System would be preferable when compared to FA, because it would address the problems of income shifting present in the ALS, without the distortive and manipulative effects that are inherent to FA. In this sense, they consider that ALS is too permissive to aggressive transfer pricing strategies, but also rejected the allocation of income arising from FA alternatives.

Additionally, they regard that their proposal would be “the only approach to international income taxation that is consistent with the fundamental principle of ability-to-pay that underlies the choice of income as the primary base for taxation of U.S. residents.” In their comprehension of the issue, both the ALS and the FA fail to take the ability-to-pay into consideration, since they do not compute the full income of the US resident.

The fundamental critique that could be addressed to the Fleming Jr., Peroni and Shay proposal is the same that could be generally applied to any and every “Real Universal Taxation System”. It takes Capital Export Neutrality (“CEN”) as the paradigm to be pursued in international taxation, thus ignoring the differences in infra-structure and provision of public services existing among States. In their understanding “worldwide, non-deferred taxation is the least distortive in regard to the question of where to locate business investment and activity”. Accordingly, States adopting worldwide taxation argue that investors should be subject to the same level of taxation in their inbound and outbound investments. This would avoid a distortion in their decision and the most efficient allocation of resources would be achieved.

There is no international consensus regarding to this perspective. On the contrary, it seems very convincing that CEN does not work efficiently. Should the tax credit mechanism work according to its aim – i.e. neutralize tax burden – then this would not imply neutrality in investors’ decisions. On the contrary: equalization of tax rates is a mechanism to convince investors not to invest in less developed countries.

Klaus Vogel’s contribution to this debate is precise. One can easily assume that there is some relationship between tax rates and services provided by States. Although some jurisdictions demand high taxes and do not offer their taxpayers a corresponding level of services, due to States’ own deficiencies, it is true that a State will not be able to offer good services if its taxation is too low. One can generally say that if the jurisdiction charges lower taxes, taxpayers must be prepared to supplement some services which could otherwise be offered by States. If one takes this perspective to a relationship between developed and developing States, one can consider that developed States will
usually impose higher taxes, but on the other hand, their taxpayers will have a stronger State. Developing States may have lower taxes, but one will easily note some deficiencies, including those related to infrastructure. In such scenario, neutralizing tax burden means to require taxpayers to pay the taxes on the same level, independent from whether they invest in their own residence state or abroad. This is not neutrality: under the same level of taxes, investors will prefer to invest in an environment where infrastructure corresponds to the level of taxes he is paying. It does not make sense to invest in a jurisdiction which offers less infrastructure, since investor will have to pay for services which would otherwise be offered by State. In other words, when a developed State adopts capital export neutrality, it invites its taxpayers to invest locally (or in another developed State); investors will only dare to invest in developing States if their remuneration is high enough to make such investment attractive in spite of the gap between (developed State) tax level and (developing State) infrastructure. One should not be surprised therefore if one would note a relevant spread between interests paid by developed States vis-à-vis developing States. Vogel goes further taking this to an interstate relationship, capital export neutrality will be even more inacceptable, since one will note that it implies keeping relevant resources in developed States, while developing States need such means for their development. Furthermore, Residence States can tax the income of their resident taxpayers upon consumption but Source States can only tax the income upon payment.

Besides, the “Real Universal Taxation System” is specifically addressed as a reform to the U.S. international tax system. In their understanding the US currently holds a “de facto, poorly designed, and elective quasi-territorial system”, which would encourage US-based MNEs to locate their businesses in low-tax foreign countries. Accordingly, under its current system, the US would have chosen to “encourage and reward the creation of low- and zero-taxed foreign source income through aggressive transfer pricing.”

They therefore adopt premises that could only be valid in the context of the U.S. tax system. For instance, when addressing a reform to the tax residency rule - an important part of the proposal -, the authors suggest a model based on shareholding instead of place of effective management. The shareholding-based residency rules, however, would only be effective in a “post-FATCA world”, where it would be possible for publicly traded corporations to know whether they are controlled by U.S residents or not. Absent such technology, it is evident that tax authorities would lack the necessary means to apply shareholding-based residency rule.

This is a limitation of the proposal which is coherent with one of its basic premises. The authors consider that a multilateral agreement concerning the formulary approach would not be practical, deeming a unilateral action by the US as the most viable solution.

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One should note, on the other hand, that the proposal would engender a crediting issue, unless taxes paid abroad would be credited against US tax irrespective of whether they relate to foreign or US income. Accordingly, under the present system, only taxes on foreign income would be offset against US taxes. Should this rule be maintained, then the whole transfer pricing issue would revive as to determine whether there is, or not, foreign sourced income.

IV. WHAT THE TRANSFER PRICING DEBATE HAS BECOME

The transfer pricing debate has become the battleground for broader reforms of the international tax regime. Opponents of the ALS have suggested approaches that are more focused on shifting taxing powers than on solving real feasibility issues of transfer pricing. The alternatives described imply not only an increasing capacity of the State on the collection of tax revenues, but also engender the taxation of profits that would not be taxable (at least by the same State) under the current regime.

According to Richard Vann, the clash between ALS and FA is a contest on whether consolidation or separate-entity concepts should govern. He essentially advocates that transfer pricing should evolve from a transactional to a “whole of the enterprise approach”.

Hence, the fact that consolidation systems are increasingly being upheld by domestic legislations would be a strong argument in favor of the adoption of FA in transfer pricing legislation.

When one advocates the adoption of FA as opposed to ALS, it becomes clear that the very rationale behind the transfer pricing legislation has been put aside. Accordingly, as seen above, the ALS is a tool designed to determine the market profit of an entity. FA has nothing to do with this scope. FA is not a reliable tool to compare taxpayers within a community. In other words, there is a subjective divergence between FA (based on consolidated profits) and profits of local independent taxpayers. Moreover, FA is not aimed at determining the income derived by the entity, but rather splits profits earned by the whole group. While ALS is designed to determine the market profit (proxy) of an entity (subject) in order to determine its ability-to-pay (criterion of measurement), FA simply leaves this analysis aside and searches a different criterion for the taxation.

This shows that it is methodologically incorrect to compare ALS with FA. ALS is a tool to determine market income. It is a proxy to reach ability-to-pay which, finally is a criterion to share the tax burden among taxpayers. FA, on the other hand, is a criterion to determine the “fair” amount that MNE should contribute to each community where the group is present. This shows that a comparison may be done between ability-to-pay and FA, both as different criteria for taxation, never between ALS and FA, since they are logically different categories.

The above framework is also relevant to demonstrate how the FA is inferior to the ALS in terms of fairness and of allocation of tax burden among the taxpayers (“Lastenausteilungsfunktion”), thus bringing back the transfer pricing debate to the discussion of its original intent.

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115 Id., at 135.
116 Id., ibid.
As per the principle of equality, it is not enough that the law is applied identically to any and every taxpayer; it is also mandatory that the law itself does not include an arbitrary distinction. In this sense, it may be regarded that the FA is methodologically flawed because it elects illegitimate proxy for determining the taxable income in an operation. If the function of transfer pricing rules is to determine market income in order to allocate the tax burden among taxpayers as per their ability-to-pay, any standard of measurement that does not relate to the ability-to-pay is arbitrary. Payroll or local of sales are not proxies that ultimately lead to a conclusion with respect to the market income. From this perspective, FA harms equality, by imposing tax burden on entities that have not derived any market income at the same time it relieves from taxation entities that have actually earned profits.

In other words, FA disregards the actual function of transfer pricing rules. The immediate function of transfer pricing rules is not the allocation of income among States. The allocation of income among States is, indeed, one outcome of the application of transfer pricing rules. But transfer pricing rules should be designed to determine the taxpayer’s taxable (market) income according to their ability-to-pay, which includes combating the tax avoidance inevitably enabled by the structure of MNEs.

It could be argued that FA does not disregard the ability-to-pay. Actually, the argument goes, the taxpayer taken into account in a FA-based transfer pricing legislation would be the MNE as a whole and the formulae would merely allocate parts of this calculated income among states, following supposed economic allegiance criteria. Under this perspective, the “subject” (i) would be the MNE, and not the separate entity.

However, this argument actually implies even worse problems, since in essence it includes claims according to which: i) there is an ultimate unquestionable profit of the MNE, which could be determined by a consensus with respect to the consideration on revenues and expenses; ii) this profit should be considered for the allocation of income among States; iii) this profit should be allocated by reference to elements that bear no relation with the profitability of the MNE.

Additionally, it must be highlighted that authors supporting the FA rely on the justice of a negotiated solution to transfer pricing. A negotiated solution, with no principle-based ground for the taxation of MNEs, as is the case of the FA, would merely shift tax revenues to States that have a superior bargaining position in the international scenario. In this perspective, the fairness of the method would be derived from the proceeding that led to its implementation. In other words, the method would be fair because it has been voluntarily accepted by the contracting States. The principle of equality, which would be the basis for transfer pricing adjustments, would be simply disregarded.

In the same sense, it may be considered that the “Real Universal Taxation System” is a contest on whether Capital Export Neutrality should be the paradigm of international taxation, or if the States should remain free to elect how to tax the operations of the MNEs based in their territories. One should recognize that such System, different from FA, actually aims at determining the income of the parent company and can therefore be compared with the ALS. It is immediate, however, that while ALS is a standard which is targeted to determine the profit of an entity irrespective of its position as a controlling or an affiliated company, Real Universal Taxation System has a much reduced
application, since it only works for some companies within a group. This is already an explanation for why the ALS should be preferred. Additionally, while the ALS aims at determining the (market) profit of the entity, the Real Universal Taxation System comprehends profits of several companies of a group altogether.

Moreover, the Real Universal Taxation System is based on CEN. As already argued above, there is no consensus as to the choice of CEN. Klaus Vogel’s perspective of the question should not be disregarded, especially in the present days, where more and more countries tend to adopt a territorial system where dividends from foreign active investments tend to be exempted.

Finally, the taxation of intangibles would remain as an issue both under the FA and the Real Universal Taxation System. In the latter case, “income would still have to be characterized as foreign-source or domestic-source for purposes of the U.S. foreign tax credit limitation”117.

These proposals have a common background: they imply starting over again, giving away a half-century experience on the application of transfer pricing rules. On determining which should be the factors for formulary apportionment, it has already been recognized there would be no “magic set of factors”, and their establishment would be “a complicated process of trial and error”118. In other words, if there are problems with the current ALS, many other problems would also be derived from the FA and Real Universal Taxation proposal.

FA would require that parties are able to estimate the group’s global profits (what would demand a level of cooperation among jurisdictions) and, furthermore, would demand a consensus on their distribution. However, as Ditz correctly recalls, a similar problem has appeared in a much smaller scale, i.e., within the 27 EU-Members, and no consensus seems to be reached in the near future concerning the CCCTB and the key of distribution. Considering that FA would depend on consensus among much more diversified jurisdictions, its feasibility does not seem likely to occur119.

The Hybrid Solutions, finally, are apparently characterized by a very strong skepticism. At first glance, authors who contend such an approach are not concerned with the justice on the allocation of income among taxpayers or States, as long as such income is somehow taxed. However, as FA is essentially a negotiated solution, with no further principle-based grounds, it may be concluded that these authors take for granted the fairness of such a negotiation.

The present article, as it essentially provides additional considerations on the application of the current ALS-based rules, is intended to build on previous experience. The mere fact that over 3,000 tax treaties are presently in force adopting the ALS seems to be an argument strong enough to support this initiative, especially taking into account that the other alternatives are not likely to be more efficient or fair, and would, moreover, not be in accordance with treaties in force. This perspective, however, should not be seen as a

conformist solution, but rather as an expression of belief on the justice underlying the ALS.

V. BACK TO THE ORIGINAL INTENT: BEYOND THE OECD GUIDELINES

V.1. Transfer Pricing as a matter of equality: back to the original intent

The analysis above seems sufficient to support the adoption of ALS: different from the other solutions proposed in the literature, the ALS is aimed at determining the profits of (single) entities and therefore maintains profits as a preferred proxy to apply ability-to-pay as a criterion of measurement to distribute tax burden among taxpayers within a community. In summary, if ability-to-pay is justified as a criterion, then ALS is an adequate tool for its application. Moreover, standing on ALS is clearly preferable from a practical perspective, considering that thousands of tax treaties around the globe adopt this standard as a limitation for transfer pricing adjustments.

The option for ALS does not mean that the limitations described above should be disregarded. However, since the ALS is not a target by itself, but a mere tool to determine the income of an entity trading with related parties, then some of the issues can be overcome, provided that the final scope (fairness in the distribution of tax burden) is not jeopardized.

In this sense, the Glossary of the OECD Guidelines defines “arm’s length range” as “[a] range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm’s length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods”\(^{120}\). The affirmation of an “arm’s length range” in place of a single and undisputable arm’s length price implies the acknowledgment of a gradual discretion involved in the application of the ALS. Since, however, the equal treatment of taxpayers derives from equality, there is a need not only of formal consistency, but also material congruence, as in any and every equality exam\(^{121}\).

As seen above, ALS entails a legal fiction (related parties shall be taxed as if they had traded according to the ALS) and a legal presumption (methods are designed to determine how independent parties would have traded ALS).

Legal presumptions, on the other hand, shall not be arbitrary. As already seen above, there must be a reasonable relationship between legal presumptions and an acceptable reality. In the case of ALS, methods shall not be arbitrary. They should be reliable enough so to ascertain that prices reached among parties trading according to the ALS would probably reach the values determined according to the methods.

In this sense, cost-plus and resale methods, as developed in transfer pricing legislation, are very similar to pricing methods which Kotler calls Cost-Plus Pricing\(^{122}\), whereby

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\(^{120}\) OECD Guidelines, at 23.

\(^{121}\) H. Ávila, Teoria da Igualdade Tributária, supra n. 588, at 63.

\(^{122}\) “The simplest pricing method is cost-plus pricing – adding a standard markup to the cost of the product. Construction companies, for example, submit job bids by estimating the total project the total

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the company fixes prices considering a profit margin to be reached. Another pricing method which resembles said methods is the Breakeven Pricing or Target Profit Pricing. On the other hand, CUP method is very similar to the Competition-based Pricing, where company considers its competitors before fixing its own prices.

As said above, tax law only admits rebuttable presumptions, in order to avoid taxation where facts clearly do not correspond to the tax rule. Rebuttable presumptions require that evidences do not require exaggerated costs, otherwise it may be impossible to prove facts occurred differently. Roman Law already developed the concept of probatio diabolica to refer to cases where the production of evidences were excessively high, practically denying the rebuttable character of a presumption. As already mentioned, taxation is not based on facts, but on an acceptable version of facts. This is an important consideration when one discusses the costs of production of evidences (documentation) in transfer pricing matters, and the need of simplified alternatives. Evidences to rebut a presumption shall not prove a fact (it is impossible to know what independent parties actually do), but rather a reasonable version of the fact (what third parties would reasonably do).

V.2. Standardization as an alternative to feasibility problems

Simplicity and administrative efficiency are universally accepted as policy objectives. In fact, this ideal dates back to Adam Smith who asserted that the collection of taxes should involve the lowest cost possible to the taxpayer. This concern is still prevalent among economists, who emphasize transparency as a characteristic of an optimal tax system. Certainty and simplicity were also included in the “Ottawa Taxation Framework Conditions”, meant to be endorsed by all Tax Administrations of OECD Countries. Nevertheless, usually simplicity demands that equity and neutrality are put into perspective, which is raised as an argument by tax administrations to reject measures that relieve the taxpayer from compliance costs. When the matter is tax collection, tax authorities tend to present a high tolerance to complexity, apparently ignoring that equality and neutrality are inevitably sacrificed when the system is too complex, as it is currently the case of transfer pricing legislation.

The OECD recognizes that “[b]oth tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the arm’s length principle”, given that the ALS “usually requires taxpayers and tax administrations to evaluate project cost and adding a standard markup for profit. Lawyers, accountants, and other professionals typically price by adding a standard markup to their costs. Some sellers tell their customers they will charge cost plus a specified markup; for example, aerospace companies price this way to the government.” Cf. P. Kotler e G. Armstrong, Principles of Marketing, (New Jersey: Prentice Hall, 1999), at 314.

123 “Another cost-oriented pricing approach is breakeven pricing, or a variation called target profit pricing. The firm tries to determine the price at which it will break even or make the target profit it is seeking.” (Cf. P. Kotler e G. Armstrong, supra n. 1223, at 315).

124 “Consumers will base their judgement of a product’s value on the prices that competitors charge for similar products.” Cf. P. Kotler e G. Armstrong, supra n. 1223, at 318.


uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises”, which “can demand a substantial amount of data”. The problems with the obtainment of information are extensively described in the Guidelines. Available information may be “incomplete and difficult to interpret”; also, other information “may be difficult to obtain for reason of its geographical location or that of the parties from whom it may have to be acquired”. The Guidelines also point out that “information about an independent enterprise which could be relevant may simply not exist, or there may be no comparable independent enterprises, e.g. if that industry has reached a high level of vertical integration”. Problems of confidentiality are also highlighted by the OECD Guidelines. Even though, the OECD emphasizes the importance of not losing “sight of the objective to find a reasonable estimate of an arm’s length outcome based on reliable information”, deeming that “transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer”.

Such statements concerning the obtainment of information lead to a questioning on how the burden to provide this information is allocated between taxpayers and tax administrations. The OECD Guidelines report that OECD member countries disagree on whether Article 9 entails burden of proof rules. In any case, it regards that “to achieve the balance between the interests of taxpayers and tax administrators in a way that is fair to all parties”, it would be necessary “to consider all aspects of the system that are relevant in a transfer pricing case”. However, even when the tax administration bears the burden of proof and the taxpayer has no “legal obligation to prove the correctness of its transfer pricing”, the Guidelines affirm that “of course, the tax administration might still reasonably oblige the taxpayer to produce its records” that will enable the tax administration to undertake the examination leading to a prima facie demonstration that the pricing of the taxpayer is incorrect. In a statement that sounds almost threatening, the OECD suggests that “taxpayers should recognize that notwithstanding limitations on documentation requirements, a tax administration will have to make a determination of arm’s length transfer pricing even if the information available is incomplete.

Documentation requirements are considered apart from burden of proof rules. In fact, the taxpayer bears the burden of proof even when he/she does not, since if he/she is unable to comply with the extensive documentation requirement, the tax administration is entitled to “assume relevant facts based on experience”. As a consequence, taxpayers should always be prepared “to make a good faith showing that their transfer

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129 Accordingly, “[t]ax administrations should take care to ensure that there is no public disclosure of trade secrets, scientific secrets, or other confidential data. Tax administrations therefore should use discretion in requesting this type of information and should do so only if they can undertake that the information will remain confidential from outside parties, except to the extent disclosure is required in public court proceedings or judicial decisions. Every endeavour should be made to ensure that confidentiality is maintained to the extent possible in such proceedings and decisions.” (OECD Guidelines, at 185, para. 5.13).
130 OECD Guidelines, pp. 35-36, para 1.13.
131 OECD Guidelines, at 21, para. 18.
132 OECD Guidelines, at 21, para. 18.
133 OECD Guidelines, at 134, para. 4.11.
134 OECD Guidelines, at 185, para. 5.13.
135 OECD Guidelines, at 135, para. 4.12.
pricing is consistent with arm’s length principle regardless of where the burden of proof lies.\textsuperscript{136}

Not only the price must be “fair and reasonable”, but also the means established to reach such price. If reaching the “fair and reasonable” price comes at the expense of time-consuming and burdensome procedures to be followed by the taxpayer, then one may not speak of privileging the principle of the ability-to-pay. In fact, in such cases, the tax collection, and not the ability-to-pay, is being privileged.

Under such circumstances, a reconsideration on the present rules should be made. If one takes into account that documentation is at the end of the day, necessary for the application of one method foreseen by legislation and the latter implies a (rebuttable) presumption as to what would be the price in a transaction according to the ALS, which finally is relevant for the adequate calculation of the market profit of an entity as a criterion of measurement of its ability-to-pay, then the whole issue may present new colors. There is enough distance between the evidence produced (documentation) and the final result (ability-to-pay) and one may ask whether the latter could not be reasonably reached under a less burdensome process and, furthermore, whether divergent results necessarily mean that one is “correct” and the other “wrong”. After all, if the scope is to reach equal treatment among taxpayers, fairness turns a more complex issue: to demand an excessive burden to reach an exact number may be far away from a fair distribution of the tax burden.

Accordingly, tax burden has been considered so far as the share each taxpayer supports for common expenses. This is the amount of taxes paid. Such a concept, however, disregards that taxpayers are not only subject to pay taxes: they must moreover fulfill several other requirements foreseen in tax legislation. These procedures produce what is generally known as compliance costs, i.e., invisible expenses incurred by taxpayers, which despite not included in public revenues, clearly represent the assignment to taxpayers of tasks which are in the interest of tax authorities. If fairness is the final scope of transfer pricing legislation, then not only the amount of taxes plays a role, but also the compliance costs. It is not enough to ensure that two (according to their ability-to-pay) equal taxpayers are subject to the same amount of taxes, when there is a huge difference in compliance costs incurred.

Fairness, therefore, require reasonable means to identify the ability-to-pay. In the field of transfer pricing, when one considers the above limitations of the ALS, it turns clear that there is no justification for exaggerated compliance costs, if one knows that the final result will not be a precise number, but rather a range. A balance between costs and results is necessary and compromise solutions may reach better results.

Under such perspective, the adoption of simplification methods and standardizations is not necessarily against the ALS. On the contrary, this may rather imply a better result taking into consideration fairness as its final scope.

V.2.1. The Rebuttable Fixed Margins Method

\textsuperscript{136} OECD Guidelines, at 134, para. 4.16.
Recognizing that simplification and standardizations in transfer pricing may be an important tool to reach fairness as its final scope allows one to consider different alternatives currently discussed in the international scenario. Different from FA, the alternatives to be discussed do not disregard the ALS; on the contrary, they are thought as means to give the ALS a feasible perspective, envisaging the main difficulties and suggesting compromise solutions.

Despite initially not active on transfer pricing issues, the work developed within the UN should not be disregarded, if one intends to consider transfer pricing from a broad perspective, which does not only take into account the OECD members. Accordingly, the emergence of BRICS should be evidence enough as to the limitations of the OECD, when it intends to reflect global practices.

Even though the UN Model and respective commentaries are clearly inspired by the precedent OECD works, there are eloquent examples in which both Models diverge. An important divergence refers to the adoption of the Authorized OECD Approach (“AOA”). The UN 2011 Commentaries expressly reject the adoption of the ALS to relations with permanent establishments, inserted, as from 2010 in the OECD Model. The UN understands that such proposal would conflict with Article 7(3) of the UN Model, which forbids the deduction of values paid by a permanent establishment to the parent company, if such values are superior to the mere reimbursement of effective expenses\textsuperscript{137}.

Recently, the UN took a very strong step towards playing a more relevant role in the discussions concerning transfer pricing. The publication of its United Nations Practical Manual on Transfer Pricing for Developing Countries by the UN Committee of Experts on International Cooperation in Tax Matters should be seen as a landmark in the discussion, since, differently from the approach the OECD had adopted so far, the Manual is open to consider different practices and to evaluate their pros and cons.

The United Nations Model Double Taxation Convention between Developed and Developing Countries is an important source for countries on the development of their transfer pricing legislation. Although it confirms that the ALS has been adopted in its Model Convention (Art. 9), the UN also mentions other alternatives, such as the FA, and is also a very comprehensive material to understand the different approaches to transfer pricing adopted by non-OECD countries.

Since the focus of the present article is the ALS standard (which is present in thousands of tax treaties around the globe), it is interesting to see how the Manual evaluates an alternative adopted in Brazil: the Rebuttable Fixed Margins Method.

This article is not intended to describe in detail the Brazilian transfer pricing legislation\textsuperscript{138}. It is clear that in several aspects, the Brazilian legislature has not followed the OECD Guidelines. Especially relevant is the use of fixed profit margins, which is not addressed in the OECD Guidelines.


\textsuperscript{138} For an extensive analysis of the Brazilian legislation, see L. E. Schoueri, Preços de Transferência no Direito Tributário Brasileiro (3rd ed., São Paulo, Dialética, 2013), 479p.
This article sustains that the fact that the OECD Guidelines do not refer to the fixed margins does not necessarily mean that the Brazilian approach cannot be improved in order to be considered an ALS-based method, compatible both with the UN and the OECD Model Conventions.

For a better understanding of this idea, one should keep in mind the idea presented above concerning the legal nature of transfer pricing. The author believes that there is a legal fiction (to grant the same treatment to controlled transactions as if they were ALS) and a rebuttable presumption (that ALS can be reached through the methods foreseen by law). In this case, fixed margins are a mere extension of a generally accepted legal presumption.

As a matter of fact, there does not seem to be much dispute in literature concerning the generally adopted legal presumption that the application of transfer pricing methods (consider RPM, for instance) can reach values which would be reached in a transaction between unrelated parties (ALS). Several countries adopt similar methods and their efficiency is generally accepted. The fixed margins imply a modification in the presumption: while generally countries rely on the result of a method but do not fix a margin for the application of the presumption, the Brazilian approach relies on a legal presumption which includes a fixed margin.

In other words, while a generally accepted approach would be, for instance, that a price according to the ALS would be obtained through a resale price diminished by a margin to be established according to a margin based on a functional analysis, the Brazilian legislator deems to be according to the ALS the resale price diminished by a fixed margin. In both cases there is a presumption that the correct application of the method results in a price according to the ALS.

Under such perspective, the discussion on the Brazilian approach is much simpler: to determine whether there is enough reasonability on the presumption that unrelated parties deal according to the fixed margin.

The Brazilian fixed margin was not disregarded by the UN Practical Manual, which, while reporting on FA experiences, considers that Brazilian legislation “set out a maximum ceiling on the expenses that may be deducted for tax purposes in respect of imports and lay down a minimum level for the gross income in relation to exports, effectively using a set formula to allocate income to Brazil.”

V.2.2 RFM is different from FA; RFM according to the ALS

Reducing the Brazilian approach to a FA alternative is misleading. The Brazilian Approach does not pursue a division of the global profit of the MNEs among the entities. Neither does it take into consideration the amount of profits to be paid to the other entities of the group. The Brazilian legislation only takes into consideration the profits of the Brazilian entity. Therefore, it is clearly not a FA-based method, since neither does it takes into account the global profit of the MNE, nor does it disregard the

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intra-group transactions. The fixed margins approach is essentially a transactional ALS-based approach.

As per the fixed margins approach, countries may establish “different profit margins per economic sector, line of business or, even more specifically according to the kind of goods or services dealt with, to calculate the parameter price”\textsuperscript{140}, on the application of the relevant ALS-base methods. The profit margins must be determined with basis on market researches. These pricing researches could be both carried out by the tax administration, or purchased from third parties, being important that it is previously submitted to discussion with the economic groups to which they will be applied.

If the legislation establishes numerous and very specific margins, the chances that the applicable margins correspond to a consensus concerning reality increase. The Brazilian Chapter on the UN Practical Manual highlights that in some cases the existence of many different margins may not be necessary, depending on the diversity of goods and services exported and imported by the country\textsuperscript{141}. Determining how numerous and how specific the fixed margins is deemed to be a policy decision, which may vary according to the characteristics of the State’s economy\textsuperscript{142}.

The legislation may establish fixed margins by economic sector (distinguishing, e.g. extraction or production of raw materials, manufacturing and services) or more specifically with reference to the relevant activities of the MNE. As suggested by the UN Practical Model, “the country could use a margin for the chemical industry as a whole, or different margins for different types of products of the chemical industry (agrochemical, petrochemical, explosives, cosmetics etc)”\textsuperscript{143}.

It is important to note that the current Brazilian legislation does not include such a mechanism. The Brazilian Chapter deems possible to establish “range of profit margins”. In some cases, it would be necessary to determine a maximum and a minimum profit margin which would statistically correspond to the available relevant data of uncontrolled transactions. This range would represent “an acceptable divergence margin”\textsuperscript{144}. In this case, the legislation should establish ranges instead of margins. In case the pricing researches find out that some companies have a 25 percent margin and other a 38 percent margin, the range would be advisable instead of fixed margins, in a sense that margins within 25 and 38 percent would be acceptable. If the range becomes too wide, it may be the case for further specification concerning the products or activities\textsuperscript{145}.

\textsuperscript{140} UN Practical Manual, at 372, para 10.2.9.1.
\textsuperscript{141} UN Practical Manual, at 372, para 10.2.9.1.
\textsuperscript{142} Accordingly, “[e]ach country should determine, according to its specific circumstances, the amounts involved and types of goods and services, how specific the margins should be and whether more margins are merited. Besides, a country may combine different levels of margin specifications if it seems appropriate; it may set forth some general margins for a line of business in addition to more specific margins for some goods.” (UN Practical Manual, at 373, para 10.2.9.4).
\textsuperscript{143} The Brazilian Chapter highlights that “[t]he differentiation per industry into types of products is adopted by Brazil, where, for the Resale Price Method for imports, the margin for chemicals sector in general is 30 per cent, while the margin for pharmaceutical chemicals and pharmaceuticals is 40 per cent.” (UN Practical Manual, at 373, para 10.2.9.3)
\textsuperscript{144} UN Practical Manual, at 373, para 10.2.9.5.
\textsuperscript{145} UN Practical Manual, at 374, para 10.2.9.7.
The advantages of the fixed margins are immediate\textsuperscript{146}: i) they may avoid the need for specific comparables; ii) they can be applied both by tax administrations and the companies without the need for technical knowledge on specific transfer pricing issues, which is a scarce human resource both for companies and tax administrations in developing countries; iii) they grant legal certainty to taxpayer, since this is an \textit{ex ante} objective alternative, not relying on further subjective analysis; iv) they reduce costs for both tax administrations and taxpayers, since they diminish the need to empirically determine gross margins in a comparability analysis; v) they privilege competition among enterprises in the state, submitting them to the same tax burden.

However, if not correctly considered, the approach may be incompatible with the ALS. Despite important for tax policy considerations, the “Comments for Countries Considering the Adoption of Fixed Margins” in the UN Practical Manual ignores the need for rebuttable presumptions.

The Brazilian Chapter was written by the Brazilian tax administration and, as a consequence, it does nothing more than expressing the Revenue Service interpretation of the Brazilian legislation. Hence, it considers as a “weakness” of the method the “unavoidable” outcome “that some Brazilian enterprises will be taxed at (higher or lower) profit margins not compatible with their profitability”, which would be due to the fact that “the fixed margin method applies regardless of the cost structures of taxpayers”\textsuperscript{147}. The Brazilian tax administration also regards that “[t]he approach may lead to double taxation in case there is no access to competent authorities to negotiate relief of double taxation”\textsuperscript{148}.

Therefore, the Brazilian Chapter ignores the ALS may be inferred from the Brazilian tax legislation\textsuperscript{149} and is also included in every single tax treaty signed by Brazil\textsuperscript{150}. If the tax authorities’ interpretation is adopted, then the allegedly “unavoidable” outcome of the methods applied clearly violates provisions of the Brazilian tax system. This interpretation is liable for the worldwide rejection of Brazilian transfer pricing legislation, given that, put in the terms contended by the tax administration, the Brazilian Approach is clearly in breach to the international agreements signed by Brazil\textsuperscript{t}.

The only reasonable interpretation of the fixed profit margins is that the margins set forth by the legislation are rebuttable. The taxpayer must be entitled to bring arguments to convince that an ALS margin in the transaction described would probably be distinct.

\textsuperscript{146} UN Practical Manual, at 370, para 10.2.7.1.
\textsuperscript{147} UN Practical Manual, at 371, para 10.2.7.2.
\textsuperscript{149} Brazil currently has DTCs with the following countries (date of signature noted): Japan (24 Jan. 1967); France (10 Sept. 1971); Belgium (23 June 1972, amended 20 Nov. 2002); Denmark (27 Aug. 1974); Spain (14 Nov. 1974); Sweden (25 Apr. 1975); Austria (24 May 1975); Italy (3 Oct. 1978); Luxembourg (8 Nov. 1978); Argentina (17 May 1980); Norway (21 Aug. 1980); Ecuador (26 May 1983); the Philippines (29 Sept. 1983); Canada (4 June 1984); Hungary (20 June 1986); Czechoslovakia (now the Czech Republic and Slovakia) (26 Aug. 1986); India (26 Apr. 1988); Korea (Rep.) (7 Mar. 1989); the Netherlands (8 Mar. 1990); China (5 Aug. 1991); Finland (2 Apr. 1996); Portugal (16 May 2000); Chile (3 Apr. 2001); Ukraine (16 Jan. 2002); Israel (12 Dec. 2002); Mexico (25 Sept. 2003); South Africa (8 Nov. 2003); Venezuela (14 Feb. 2005); Peru (17 Feb. 2006); Trinidad and Tobago (23 July 2008); and Turkey (16 Dec. 2010).
from the margin reached by the tax administration, or would not fall within the range of margins provided. A distinct interpretation would imply a violation both to domestic legislation and tax treaties providing for the ALS. When one reads the text of Law 9,430/1996, as amended in 2012, it is clear that margins may be revised. Unfortunately, this has not been a practice in Brazil. It is difficult to determine the reason why taxpayers have not challenged the determined margins. It is true that previous legislation required an enormous documentation for any application for revision of margins, which made any such request virtually infeasible. However, said legislation is not in force anymore, what could offer taxpayers and tax administration the opportunity of discussing industry-specific margins. The circumstance that this has not occurred so far may be considered the major weakness in Brazilian practice. This shows that Brazilian present practice may not be considered as a final solution, but rather a methodology under construction.

Another failure of the RFM, as presently existing in the Brazilian practice, is that there is scarce evidence concerning the methodology employed to reach the fixed margins. Such opacity implies a clear lack of legitimacy of the presumption itself, since no one can convincingly argue that margins are reasonable, or not. A further development of the method seems therefore necessary for the methodology, as well as the data collected and employed, to be transparent, thus allowing a control of the presumption.

Under such conditions, the Rebuttable Fixed Margins Method (“RFM”) contended in the present article can certainly be compatible with the ALS and could be seen as an important tool to circumvent the feasibility issues presented in the first part of this article. As already mentioned above, the Brazilian present practice is not what the author claims to be a final solution: it should be considered as an alternative under construction, which demands further corrections.

In order to comprehend how the RFM, provided that the adaptations mentioned above are adopted, is compatible with the ALS, this article provides a theoretical framework, able to situate the ALS in the relevant principles that are generally enthroned by tax systems.

V.2.3. RFM as standardization

The RFM is essentially a method that provides for norms with a simplification function. The method is intended to standardize the application of the ALS and, as a consequence, it may put into perspective the justice on particular cases. However, the mere fact that the real value and the value achieved by the application of the fixed margin are not always identical does not imply the need for rejecting the standardization.

In the standardization, the principle of the ability-to-pay is not left behind. Standardization implies the option for achieving equality by the consideration of

151 Unfortunately, the tax administration still does not share this perspective (See, e.g., Brazilian Administrative Council of Tax Appeals, Judgment No. 108-09.763, decided on 11.13.2008; Judgment No. 1401-000.801, decided on 06.12.2012). Not surprisingly, the tax treaty concluded with Germany (27 June 1975) was denounced by the German authorities on 7 April 2005 due to disagreements that include also transfer pricing issues.
elements presumably present in the majority of the cases\textsuperscript{152}. For this reason, unlike the RFM, the FA alternative may not be deemed as a form of standardization, considering it has no direct relation with the profitability of the entities in a MNE and, as a consequence, it does not comply with the principle of the ability-to-pay.

Ávila’s theory of tax equality proves itself useful to evaluate whether a given standardization is compatible with the principle of equality. According to this theory, the criteria to examine whether the standardization complies with the principle of the ability-to-pay are: (i) necessity; (ii) generality; (iii) compatibility; (iv) neutrality; (v) non-excessiveness; and (vi) adjustability\textsuperscript{153}.

With respect to the necessity (i), the ground for the adoption of the RFM is the extreme burden transfer pricing legislation entails to taxpayers as to comply with the auditing requirements. The proposals for abandoning the ALS, which are mostly grounded in the complexity of the method, are enough to conclude that such a measure is necessary.

The generality (ii) is an important element as to analyze the feasibility of the RFM in certain cases. The standard must concretely reproduce a trend in real cases. The legal standard must be adequate to the majority of the taxpayers the fixed margin covers. In order to find which should be the group of taxpayers to which the fixed margin should be applicable, the considerations contained in the Brazilian Chapter of the UN Practical Manual should be followed.

There will be many cases where finding a standard profit margin will not be possible, since the standardization will only be valid where it implies minimal adverse effects. In such cases, the RFM should not be applied. In other words, the standardization is not intended to perpetuate inequality, but, on the contrary, it shall be specifically designed to pursue the equality among taxpayers. The standardization is only tolerant with accidental discrepancies between the deemed profit margin and the profit margins effectively observed in unrelated parties’ transactions.

The compatibility (iii) means that the chosen standard must reproduce reality not only prior to the enactment of the legislation, but also after its application by the adjudicating authority. Likewise, the neutrality (iv) forbids unjustified interference by the State on the economic activities of the taxpayer. The application of a standard shall lead neither to a (excessive) interference on the competition between companies, nor to an excessive burden on some taxpayers in the detriment of others. The need for non-excessiveness (v) implies that the application of the standard may not lead to confiscatory measures.

Most importantly, the standardization can only be deemed valid if the adjustability (vi) is granted to the taxpayer. It may happen that, despite being valid as a general rule, the standardization implies a more intense effect on given taxpayers, whose particular circumstances move them away from the general rule. As a consequence, standardization demands the inclusion of a hardship clause (“Härteklausel”), whereby a concretely fair distinguishing is granted to the taxpayer\textsuperscript{154}. In this sense, it is essential to interpret the fixed margins in transfer pricing legislation as a rebuttable margin, in order to consider this method as compatible with the ALS.

\textsuperscript{152} H. Ávila, 
\textit{Teoria da Igualdade Tributária}, supra n. 588, at 89.

\textsuperscript{153} H. Ávila, 
\textit{Teoria da Igualdade Tributária}, supra n. 588, at 94-113.

\textsuperscript{154} H. Ávila, 
\textit{Teoria da Igualdade Tributária}, supra n. 58, at 105.
It is important to highlight that the RFM is only one example of standardization. Its application in the Brazilian tax system is far from the ideal, but, if the respective taxpayers’ rights are granted, there are reasons to conclude that the standardization may represent an alternative for the ALS feasibility issues. This article contends that scholars should seek additional elements which could allow some form of standardization in transfer pricing issues and provides a theoretical framework as to determine their compatibility with the ALS.

Transfer pricing analysis has become too fact specific and measures intended to simplify the system have been rejected on the grounds of an absolute need for comparability analysis. However, the correct comprehension of the ALS as a standard of measurement oriented toward implementing the equality among taxpayers and privileging the principle of the ability-to-pay leads to a reconsideration of this statement.

V.2.4. Compatibility between the RFM and the OECD-MC

The RFM, as well as any standardization drafted according to the framework provided for in this article, shall be considered compatible both with the OECD and the UN Model Conventions.

The ALS, as set forth in tax treaties, imply a limitation to the States’ taxing power. Actually, if it is uncontroversial that taxation may not exceed a State’s jurisdiction, it is also correct to say that domestic tax law may not provide for a matter which is not within the State’s jurisdiction due to a limitation of jurisdiction set forth by a tax treaty. Hence, the adequate understanding of the relation between domestic rules and tax treaties must consider the notion of jurisdiction, instead of being addressed as a hierarchy issue.

Article 9(1) of the OECD-MC sets forth that profits that would have been derived in controlled transactions if they were carried out at arm’s length “may be included in the profits of that enterprise and taxed accordingly”. The authorization included in Article 9(1) has the ALS as a limitation. According to Article 9(2), if “the profits so included are profits which would have accrued to the enterprise of the first-mentioned State” at ALS, then “that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits”. Article 9 does not demand that all the profit that would be derived in an ALS situation is included in the taxable base of the enterprise, but rather obliges the contracting State to respect the inclusion made by the other contracting State if “the profits so included are profits which would have accrued to the enterprise of the first-mentioned State”. Also, even if the other contracting state makes

155 In this sense, one may recall the recent trend among German scholars and case law, as per the treaty override is, as a rule, deemed unconstitutional. For a contextualization of the ongoing debate in Germany, see A. Rust and E. Reimer, “Treaty Override im deutschen Internationalen Steuerrecht”, 24 Internationales Steuerrecht (2005), pp. 843-849; Moris Lehner, Treaty Override im Anwendungsbereich des § 50d EStG, 11 Internationales Steuerrecht (2012), pp. 389-404; Andreas Perdelwitz, Treaty Override – Revival of the Debate over the Constitutionality of Domestic Treaty Override Provisions in Germany, 53 European Taxation (2013), pp. 446-447.

156 For the author’s opinion with respect to the relation between tax treaties and domestic legislation, see L. E. Schoueri, Treaty Override: a jurisdictional approach, Intertax 682 (2014).
no inclusion at all, the State is solely entitled to include the profits that would have been derived in an arm’s length situation.

From the application of the RFM, three outcomes are possible: i) the transfer pricing reached is within the ALS range; ii) the transfer pricing achieved is not within the ALS range, on prejudice of the taxpayer; or iii) the transfer pricing achieved is not within the ALS range, on prejudice of tax collection.

The first case is the outcome pursued by the drafting of the legislation. If the pricing of the transaction is within the ALS range, then the standardization has provided both the taxpayer and tax administration with the benefits expected, ensuring that the transaction is taxed according to the ability-to-pay.

In case the transfer pricing is not within the ALS range, on prejudice of the taxpayer, the taxpayer is entitled to question the applicable fixed margin. If the profit margin is rebuttable, the taxpayer must be able to prove, grounded in a comparability analysis, that a profit margin according to the ALS would be above the standard set by the tax administration.

The fixed margin will only be challenged by the taxpayer if the taxation under the fixed margin is higher than the taxation under his actual margin, plus the cost of litigation the taxpayer will face, which includes all the relevant costs arising from the allocation of the burden of proof. If the fixed margin is equal or lower than the actual margin, the taxpayer will settle for the fixed margin. In this sense, the tax administration should consider reviewing the fixed margins whenever it detects a situation that keeps a group of taxpayers away from the standard defined.

From a rational perspective, in this sense, the higher the fixed margin established by domestic legislation, the higher the amount of litigation entailed by the fixed margin system. The fine balance between litigation and tax collection is a matter of tax policy. Obviously, an excessively high fixed margin, not corresponding to reality will be useless, because instead of bringing simplicity to the system, it will only engender a need to carry out comparability analysis in the form of litigation. In addition, the fixed margins will be incompatible with the criteria for standardization developed in the present article. On the other hand, an excessively low margin will imply giving away tax revenues that could be collected if the margins were more precisely determined.

Despite these considerations, it could still be argued that, due to the wording of Article 9(1), the application of the RFM could lead to a double taxation situation. One State could reject the inclusion of profits made by the other State due to the application of the RFM, thus refusing to make the corresponding adjustment under Article 9(2). In such case, the treaty would not achieve its main function, which is to eliminate double taxation.

However, this may not be deemed as an outcome attributable to the RFM, because it is rather a consequence of applying the ALS under the conditions set forth in Article 9 of the OECD-MC. In other words, the possibility that the contracting parties disagree with respect to adjustments is not an exclusivity of the RFM, being present in all the ALS-based methods. Quoting a decision of the German Court of Finances of 17.10.2001, which correctly stated that there is not one sole comparable price, but a range ("Band")
of them, as well as a similar understanding of the German Tax Administration, Ditz brings a relevant argument: also in the market one will find comparable goods or services offered for different prices.\footnote{X. Ditz, Grenzend des Fremdvergleiches, supra n. 555, at 117.} In such scenario, it is very likely that contracting States shall find different adjustments, all compatible with the ALS. The OECD-MC does not solve this question, since it does not answer which should be the State entitled to make the inclusion set forth in Article 9(1). Where both States are entitled, being the other State obliged to make the corresponding adjustment, it is possible that the States do not achieve the same conclusions with respect to which should be the adequate inclusion under Article 9(1), thus refusing to make the respective adjustment under Article 9(2).

At this point, it is important to distinguish which are the deficiencies of the RFM and which are the deficiencies of the ALS-based methods in general. The risk of a disagreement with regard to the inclusion of profits is certainly not a peculiarity of the RFM, but is actually an issue which the OECD-MC has never managed to solve, and is still an open question to any and every ALS-based method.

It may well be the case that the States disagree when applying CUP, RFM, TNMM, or any of the other methods. Applying the traditional ALS-based methods is no safer bet than applying the RFM: both cases entail the risk of double taxation due to the very nature of the ALS and to the inability of the OECD-MC to deal with this risk.

\textbf{V.2.5. RFM from a Global Perspective}

OECD Guidelines require tax administrations to be prepared to thoroughly understand controlled transactions to be audited. Functional analysis and documentation are clearly not a simple issue. Not only taxpayers face enormous compliance costs, but tax administrations themselves must be adequately prepared.

Extending the OECD Guidelines beyond the members of the Organization requires differences among countries to be seriously taken into account. While one can believe that developed countries (should) have enough personnel to evaluate such complex issues, this is not a reality which can be expected from the majority of countries around the Globe. Not only tax administrations of developing countries tend to be very small comparing to their needs. Tax auditors´ familiarity with international tax issues is not common in such scenario. It is not rare that tax administrations lack personnel prepared for reading documents written in English. Under such circumstances, requiring complex auditing procedures cannot be taken seriously. This is already an important factor to support the adoption of simple procedures, like the RFM.

Of course one cannot say that the RFM derives from the OECD Guidelines; unlike the UN Manual, the OECD does not consider this alternative. However, one should note that the Organization has moved in the direction of considering the difficulties of developing countries. An important step can be seen in its revised guidance on safe harbours provided by its Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines of 16 May 2013. The Organization declares that its primary target is to reduce compliance costs for taxpayers and to reduce administrative demands on tax administration, but it recognizes, on the other hand, that “the careful use of safe
harbours – particularly safe harbours that are negotiated on a bilateral basis between the countries’ competent authorities, can reduce the need to obtain comparables for specific transactions”, what “may provide a viable alternative to comparables based analysis in some circumstances”. The Organization admits even “regionally developed safe harbours for regions that share common characteristics”, and that “additional guidance or direct assistance could be provided to developing countries with regard to safe harbours”. It is interesting to note that this statement derives from a request made by the G8, under the United Kingdom’s presidency, “to find ways to address the concerns expressed by developing countries on the quality and availability of the information on comparable transactions that is needed to administer transfer pricing effectively”. The circumstance that the paper expressly refers to the UN Manual, and to the challenges reported therein concerning the obtainment of adequate information for the application of the ALS by developing countries, seems to be an enormous signal that the OECD may be willing to take the transfer pricing as a global problem, where non-members difficulties must be taken into account.

When one takes the developing countries’ perspective into account, one should consider, moreover, that such countries usually do not have enough savings to finance their development. Foreign investments are, in this context, a question of major importance. Although it is true that foreign investors may be attracted by reduced taxation, the role of legal certainty cannot be disregarded. Transfer pricing methodology described in the OECD Guidelines may claim to look for a fairness. One could even believe that at the end of the day, prices resulting from the application of such Guidelines are close to what would be obtained according to the ALS. However, the methods described in the Guidelines include an enormous amount of uncertainty, requiring taxpayer and tax authorities to be prepared for a long lasting discussion on the adequate margins to be applied. From a foreign investor’s perspective, there is always the risk that his/her argument will not be accepted, or even considered, due to vary factors, including the lack of experience of the tax administration. It is not surprising, therefore, that a recent research among German business community revealed a 94% majority electing legal certainty as the main scope to be reached by their transfer pricing strategy, even more relevant than the scope of optimizing tax results. In such global scenario, RFM appears as a convenient solution, since it represents, at the end of the day, a safe harbor, i.e. a predictable level of taxation.

**V.3. The BEPS Project: are we still at arm's length?**

**V.3.1. The inherent flaw: what the BEPS initiative has to say?**

Addressing the critiques to the ALS, Mitchell Kane considers that there are i) cases where “comparables literally cannot exist as a conceptual matter”; ii) cases where comparables exist but the results they entail are so diverging that they make unpractical
the application of comparability; iii) cases in which comparables do not exist in practice, but they could exist as a conceptual matter.\footnote{M. Kane, \textit{Transfer Pricing, Integration and Synergy Intangibles}, supra n. 68, at 290.}

In his understanding, the “inherent flaw” would be most present in the cases of common control value, which, by definition, could not be realized in uncontrolled transactions. Common control value would fall within the first category, in which there would be no comparables even as a conceptual matter. As he emphasizes, this category should not be confused with cases “clouded with other complexities that plague real world application of comparables analysis”.\footnote{M. Kane, \textit{Transfer Pricing, Integration and Synergy Intangibles}, supra n. 68, at 290.} This statement is compatible with the classification proposed in the first part of this article. In other words, the inherent flaw argument is not a critic to the practicability of the system. The critic to the very core of ALS takes place because “[n]o amount of searching, whether in competitive equilibrium or not, could ever hope to identify a comparable for the value associated with common control”.\footnote{M. Kane, \textit{Transfer Pricing, Integration and Synergy Intangibles}, supra n. 68, at 291.} Finding comparables, even as a conceptual matter, is impossible in such cases. It is not a mere issue of practicability.

\textbf{V.3.1.1. The inherent flaw under the perspective of model conventions}

This statement leads to the conclusion that the ALS does not take synergy rents into account. This is a strictly legal analysis, based on the interpretation of the ALS in its current wording both in the OECD and the UN Model Convention. The argument is simply that the OECD Model Convention does not entitle neither the source nor the residence State to make any sort of adjustment with reference to synergy intangibles.

Article 9(1) of the OECD-MC sets forth that any profits which would “have accrued to one of the enterprises, but, by reason of those conditions [common control conditions], have not so accrued, may be included in the profits of that enterprise and taxed accordingly”. Synergy rents are not profits that would have accrued in a non-controlled transaction. As extensively argued, as proclaimed in the inherent flaw argument, ALS fails to take these rents into consideration, in a sense that they are not allocated to any of the entities under consideration. One cannot say that at arm’s length, the synergy rents would have accrued to this or that enterprise.

Article 9(2) does not cover synergy rents as well. In the wording of the OECD-MC, the adjustment can be made if profits “so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises”. Again, a synergy rent would not have accrued between independent parties, in a sense that the States cannot make adjustments to take synergy rents into consideration.

However, as per an ambulatory interpretation of the ALS, tax administrations have tried to solve the inherent flaw by rephrasing the ALS analysis. In this updated version of the ALS, arrangements between controlled parties should be compared, \textit{e.g.,} to “arrangements that would be made between unrelated parties if they could choose to
have the costs of related parties”\textsuperscript{164}. In such rephrasing, the ALS would be capable of
taking synergy rents into account.

A similar approach is pursued by the OECD, which has already been hinted in some
excerpts of the Guidelines. Addressing the role of synergy in tax restructuring of
businesses, the OECD Guidelines consider that “[f]or Article 9 purposes, it would be a
good practice for the taxpayer to document how these anticipated synergies impact at
the entity level in applying the arm’s length principle”\textsuperscript{165}.

In the recent works of the OECD within the BEPS Project such trend has become
clearer. Juan Zornoza Pérez and Aitor Navarro Ibarrola\textsuperscript{166}, commenting the Public
Discussion Draft on BEPS Actions 8, 9 and 10, remarked that “it is virtually impossible
that transactions exclusively undertaken by MNEs – and hence transactions that
independent parties would not undertake – may respect the ALP [ALS]\textsuperscript{167}. In these
grounds, they reject the statement included in paragraph 82 of the Draft, according to
which “[…] the mere fact that the transaction may not be seen between independent
parties does not mean that it does not have characteristics of an arm’s length
arrangement”. The statement would seem “to imply a direct contradiction with the
nature of the ALP itself”. In their reasoning, the scholars consider that “it remains quite
clear that a TP rule based on the ALP require a reallocation of benefits obtained by
related parties taking into account what independent parties would have done”.

Nevertheless, in case of synergistic gains, it is not possible to state, grounded in the
ALS, that such gains belong to one of the entities in isolation, or that it “would have
accrued to one of the enterprises”. According to Kane, as the gains are a consequence of
the organization, “it is theoretically defensible to make any allocation of the surplus”\textsuperscript{168}.
Ditz confirms that from a theoretical perspective it is impossible to identify, to weigh
and to determine a key of allocation for such profits\textsuperscript{169}.

No conclusion with respect to the allocation of synergy rents can be achieved under the
ALS. That is clearly a limit of the ALS: it says nothing about gains from integration. It
is not a failure that can be corrected via ambulatory interpretation, but rather a question
of allocation of taxing rights that has not been adequately confronted by international
tax treaties following the OECD or the UN Model. The ALS was never intended to take
synergy into consideration and as a consequence, there has never been any agreement
with reference to gains from integration.

C.B., pp. 483-83.
\textsuperscript{165} OECD Guidelines, at 254, para 9.58.
\textsuperscript{166} OECD (2015), Comments Received on Public Discussion Draft: BEPS Actions 8, 9 And 10: Revisions
to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, And Special
Measures), dated February 10\textsuperscript{th}, 2015, at 511.
\textsuperscript{167} “The interpretation of a rule should not be assessed from a policy or de lege ferenda perspective, but
from the analysis of the construction of the rule itself. In this sense, it remains quite clear that a TP rule
based on the ALP require a reallocation of benefits obtained by related parties taking into account what
independent parties would have done. Thus, it is virtually impossible that transactions exclusively
undertaken by MNEs – and hence transactions that independent parties would not undertake – may
respect the ALP. Stating the contrary would imply to go beyond the possible meaning of the rule which at
the end of the day amounts to its infringement.”
\textsuperscript{168} M. Kane, Transfer Pricing, Integration and Synergy Intangibles, supra n. 68, at 292.
\textsuperscript{169} X. Ditz, Grenzen des Fremvergleiches, supra, n. 55, at 119
One must agree that “article 9 is in fact silent about the allocation of any common control premium”\(^\text{170}\). As a consequence, no adjustment intending to reallocate synergy gains is allowed under the OECD Model Convention. Therefore, the allocation of income must be kept as declared by the taxpayer, since the tax administration has no power to adjust and there is no provision concerning on which basis such allocation should be done.

V.3.1.2. The inherent flaw under the perspective of internal law

A consideration of internal law should not lead to a different conclusion: there would be no justification for adjustments which would not be based on ALS.

As a matter of fact, this article has already sustained that the ALS is a tool to reach the profit (proxy) to measure the ability-to-pay (criterion of comparison) of taxpayers trading with related parties. Transfer pricing legislation adopts a legal fiction according to which, instead of handling said taxpayers according to the effective numbers present in their controlled transactions, taxation would be as if they had dealt according to the ALS standards. In this sense, the actual values of the controlled transactions are disregarded, and the ALS values are the base for taxation.

This implies a limitation to the adjustments based on the transfer pricing legislation: no challenge may be made against the numbers presented by the taxpayers, if such adjustment is not based on the assumption that unrelated parties would have dealt in such manner.

The ALS has been presented as the key of conversion of values of controlled transactions into market prices. Any adjustment beyond the ALS would require a clear statement that it would reflect market conditions.

To express the issue the other way around: an adjustment beyond the ALS would result in prices which would not be market prices. Profits determined according to such adjustments would not be Market profits. If profits are the proxy for the criterion of comparison (ability-to-pay), it would not be acceptable that unrelated parties would have their profits estimated according to market values, while related parties would be forced to employ non-market prices.

One could correctly argue that this conclusion would also somehow lead to unfairness, since States would not be able to reach the whole amount of the group profit. This may certainly be true if the “residual profit” is left aside by both countries unilaterally applying the ALS, especially if they apply different ALS methods. However, this reasoning derives from a failure in the comparison: a difference will only be deemed to exist as far as one compares, on one hand, (isolated) entities trading with unrelated parties and, on the other hand, consolidated groups acting in different jurisdictions. If the scope of the transfer pricing legislation is to achieve fairness in the distribution of the tax burden among those acting within a community, then there is a need to identify the subjects to be compared according to the same pattern, i.e., an entity-to-entity approach. Under this (limited) entity approach, the different treatment disappears.

\(^{170}\) M. Kane, *Transfer Pricing, Integration and Synergy Intangibles*, supra n. 68, at 299.
In summary, a transfer pricing adjustment beyond the ALS would require the consideration of residual profits which may not be imputed to an entity. This subject difference is enough to prove that the principle of equality does not require a profit adjustment which would not reflect ALS.

V. 3.1.3. No Base Erosion, no Profit Shifting due to the inherent flaw

BEPS seems to be the generally accepted moto for changes in transfer pricing. Countries believe that they are missing an opportunity to tax. The inherent flaw in ALS identifies the possibility that residual profits may escape from taxation, in contradiction to the so-called “Single Tax Principle”. The author is skeptic about the very existence of such principle, but in any case, it would demand the evidence that some countries’ tax basis have been eroded, or that profits have been shifted to other jurisdiction.

When one considers tax base, one should ask how far a country’s tax law may reach. International Tax Law has debated this issue for a long time, and presently there seems to be less doubt on the issue that taxes may not reach situations beyond a country’s jurisdiction. In this sense, a country’s tax base is limited to its jurisdiction, as defined according to the elements of connection elected by internal law. Residence and source are traditionally accepted elements of connection.

The mere application of the elements of connection, however, is not enough to define a country’s tax base: if such country has a constitutional framework based on the rule of law and equality, tax base must be defined by law in a way that allows taxpayers to be compared according to criteria which can be objectively tested. As already seen above, comparison has also a subjective element, i.e., subjects to be compared must be on comparable situations. Under this perspective, it seems questionable whether groups of entities can be included within a (single) country’s tax base. As already mentioned, once a tax system adopts an entity approach to measure the ability-to-pay in uncontrolled transactions, this is a self-limitation on the tax base. In other words, profits not imputable to the entities are not per se part of a (single) country’s tax base.

For the very same reason, it is not the case of claiming that a profit shifting may have occurred upon the non inclusion of residual profits within a (single) company’s tax base: profit shifting requires a first step, whereby profits are identified as having been earned by an entity, and a second step which would shift such profit to a different (low tax) jurisdiction. If residual profits, as explained, are not imputable to any isolated entity, but rather to the group as a whole, there is logically no profit shifting, but merely a non inclusion of said residual profits.

V.3.1.4: Conclusion: BEPS initiative to tax the residual income cannot be justified under present standards

This article concludes that recognizing an inherent flaw in ALS does not imply dismissing it. On the contrary, ALS is a part of the very core of tax treaties. Its adoption in thousands of treaties condemns any initiative to overcome such standard to fail. Moreover, while the ALS is compatible with the principle of equality, any adjustment which would disregard such standard might be claimed not to be based in the ability-to-pay, thus granting similar tax treatment to incomparable realities.
Residual profits do occur. The fact that one State does not include them in its tax base does not mean that they are not taxed in the other State. This article does not claim that residual profits should be tax free, but rather that the initial allocation of the residual profit, ultimately decided by the taxpayers, cannot be legitimately challenged by any jurisdiction involved. Due to the principle of equality, a jurisdiction may expect that income earned by entities located within its territory be taxed according to the respective ability-to-pay. This is the function of the ALS. Requiring MNEs to pay taxes on income which was not generated by entities under a State’s jurisdiction might be deemed to go beyond their fair share.

An amount beyond ALS, refers to income which is not clearly derived from the activity of the entity itself, but rather from the group as a whole. There is no reason for one jurisdiction to claim to be more entitled to tax this amount, than the remaining jurisdictions. An allocation would always be arbitrary and not based on economic reasons. Ditz refers to the allocation of synergies as a question of value (Wertungsfrage). In other words, the allocation made by jurisdictions would not be better, or worse, than the allocation derived from the transaction itself.

Of course the neutrality derived from the allocation made by the taxpayer may be challenged in case such allocation implies allocating profits to low tax jurisdictions. Should this be the problem, than a better solution would be simply to resort to a discrimination of jurisdictions whose taxation is deemed “too low”. It is clear that the BEPS Project, by distorting the ALS, wishes to combat behaviours that OECD countries deem abusive. What cannot be accepted is the drafting of a whole model in order to confront situations that should be an exception.

It is a fact that hard cases make bad law. In the case of intangibles, as drafted, the very conception of the transfer pricing Action Plans is aimed at correcting a very specific situation which could be solved by discrimination. There is no need to completely jeopardized the allocation of income among the entities of an MNE as to correct an undesirable outcome of the ALS.

V.3.2. Proposals on Intangibles: the Guidelines in breach of the Convention

As from the first BEPS proposals with respect to intangibles, it has been considered that the ALS is “slowly but surely being relegated to the back seat” of the OECD Guidelines. Indeed, some approaches contended in the OECD “Guidance on Transfer Pricing Aspects of Intangibles” cannot be explained neither under the ALS, nor under any of the alternative proposals addressed herein. The effects of such statement cannot be minimized. These approaches suggested by the OECD Guidelines are actually in breach of the treaties to which the Guidelines are intended to apply.

171 X. Ditz. Grenze des Fremdvergleiches, supra n. 555, at 116
The ownership of intangibles is central to the creation of MNEs. Intangibles are assets that cannot be easily replaced and must be protected against opportunistic behavior, since they demand large investments from MNEs upon their production. If the transfer of an intangible among the entities of an MNE may be deemed essentially as a feasibility issue, as setting the price of such assets imply great divergence on valuation methods\textsuperscript{174}, the perception that MNEs are using intangibles as means to shift income to tax heavens has been enough to suggest alternatives that cannot be explained under the ALS. More dramatically, the intent to combat BEPS has led to solutions that have completely jeopardized the allocation of income, when applied to situations where the economic group rightfully intends to keep the asset under the legal ownership of a subsidiary that has not performed functions or contributed with assets or other factors that, from a BEPS perspective, engender the creation of value. These solutions are intended to address situations in which “(i) intangibles are self-developed by a multinational group, especially when such intangibles are transferred between associated enterprises while still under development; (ii) acquired or self-developed intangibles serve as a platform for further development; or (iii) other aspects, such as marketing or manufacturing are particularly important to value creation.”

One may imagine the example of a Brazilian independent company performing the extraction of poison from snakes, for the sole purpose of producing the respective serum, to supply Brazilian and Bolivian hospitals with such remedy. The Brazilian company decides to invest on research for substances able to stimulate the production of poison by the snakes, due to an increase of demand in the local market (which is, perhaps, the sole market for such product). For this purpose, as the company is not able to perform the research by itself, it decides to hire a French laboratory, which performs all the functions and provides for all the assets related to the research. The Brazilian company solely funds the research, assuming, on the other hand, the risks related to the failure of the research. By the end of the research, the French company reaches an effective formula, whose rights all legally belong to the Brazilian company, as previously agreed under a contractual arrangement. According to the ownership clause in the agreement, the French company is not entitled to any right derived from the exploitation of the intangible produced.

It is possible that a similar situation occurs between parties under common control. In the very same example, if the Brazilian company is the subsidiary of a US-based MNE, it is possible that the group as a whole has no interest in developing the referred intangible. In such case, the only option for the subsidiary will be to fund the referred research with its own resources. Within this intent, the company may choose to hire another subsidiary of the group, under the very same conditions described in the uncontrolled example, leading to an ownership of an intangible to the Brazilian subsidiary, in the same conditions as in the previous example.

How would these controlled transactions be treated for transfer pricing purposes? Under the ALS, the French subsidiary should be remunerated equally in both examples, if the transactions concerned are identical. However, when applying the approach suggested by the OECD “Guidance on Transfer Pricing Aspects of Intangibles”, there are reasons to believe that the taxation of the transaction will be distinct in each case.

\textsuperscript{174} For an extensive analysis on this issue, see Y. Brauner, Value in the Eye of the Beholder, supra n. 6, pp. 81-122.
The report puts into perspective the legal ownership of intangibles, taking it as a mere “starting point for any transfer pricing analysis of transactions involving intangibles”\(^\text{175}\). According to the proposal, “legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible”\(^\text{176}\). The OECD suggests that “[t]he return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members through their functions performed, assets used, and risks assumed”. The report even gives the example of an internally developed intangible where the legal owner performs no functions, uses no assets and bears no risks, case in which it will not be entitled to “any portion of the return derived by the MNE group from the exploitation of the intangible other than arm’s length compensation, if any, for holding title”\(^\text{177}\).

In the example described, the application of the approach suggested in the OECD “Guidance on Transfer Pricing Aspects of Intangibles” implies that, for transfer pricing purposes, the Brazilian company should not be entitled to the total of rents derived from the exploitation of the intangible. Paragraph 6.47 considers that:

As stated above, a determination that a particular group member is the legal owner of intangibles does not, in and of itself, imply that the member has the right ultimately to retain or have attributed to it the receipts that may accrue in the first instance to that member as a result of its commercial right to exploit the intangible, nor does it necessarily imply that the legal owner is entitled to any income of the business after compensating other members of the MNE group for their contributions in the form of functions performed, assets used, and risks assumed. That is, after appropriately rewarding other members of the MNE group for their functions performed, for assets used, and for risks assumed, the income of the legal owner related to the intangible may be positive, negative or zero depending on the facts of the case.\(^\text{178}\)

Hence, even if, as in the given example, the Brazilian company adequately remunerates the French companies for the activities performed and assets used, it may be the case that the Brazilian company will not be entitled to benefit from the total of rents derived in the exploitation of the intangible. As it is drafted, paragraph 6.47 leads to the conclusion that the Brazilian entity shall remunerate ad eternum the French company for the functions performed, assets used and, eventually, for the risks assumed by the French subsidiary. The report is permeated by statements that imply that the Brazilian company will never be free from the contract it signed with the French subsidiary, and a remuneration for the exploitation of the intangible shall always be paid\(^\text{179}\).

\(^{175}\) OECD (2014), Guidance on Transfer Pricing Aspects of Intangibles, supra n. 173, at 40, para 6.35.


\(^{178}\) OECD (2014), Guidance on Transfer Pricing Aspects of Intangibles, supra n. 173, at 43, para 6.47.

\(^{179}\) See, for example, para 6.63, according to which: “[t]he identity of the member or members of the group bearing and controlling risks related to the development, enhancement, maintenance, protection, and exploitation of intangibles is also an important consideration in determining prices for controlled transactions and in determining which entity or entities will be entitled to share in returns derived from the exploitation of the intangibles”.\(^\text{177}\)
It is not an exaggeration to consider that, in fact, the report forbids an ALS approach, as “[t]he need to ensure that all members of the MNE group are appropriately compensated for the functions they perform implies that if the legal owner of intangibles is to be entitled ultimately to retain all of the returns derived from exploitation of the intangibles it must perform all of the functions, contribute all assets used and assume all risks related to the development, enhancement, maintenance, protection and exploitation of the intangible”. In other words, if the entity wishes to keep all the rents derived in the future exploitation of the intangible, it must do everything alone. Otherwise, it will always owe something to its related parties.

The BEPS proposal also risks to create uncertainty with respect to “unanticipated ex post returns”. In the given example, one may imagine an event where a third party, not related to the MNE, discovers an extremely successful cosmetic application for the poison of the snake. Hence, if, in principle, the intangible developed was of restrict use, solely relevant for the Brazilian and Bolivian local market, this situation changes and an Italian subsidiary of the MNE decides to engage in the production of the cosmetic.

It may sound obvious that the Brazilian subsidiary will be extremely benefited from the supervening event, as the Italian subsidiary will be interested in paying for the outcomes of the intangible produced, and the Brazilian company is the legal owner of the intangible, since it has funded the development of the asset at arm’s length. However, some statements of the proposal demand a second look on the issue. As per the OECD proposal, the entities benefiting from these unanticipated ex posts returns “may or may not be the legal owner of the intangible, and may or may not be the entity or entities providing funding for the development, enhancement, maintenance, protection, or exploitation of the intangible”[^180].

As already mentioned above, if the problem faced by BEPS is the allocation of profits to low tax jurisdictions, a discrimination of said jurisdictions could be an alternative to the BEPS solution to intangibles. This solution cannot be derived from a correct application of the ALS and can therefore hardly be justified under the principle of equality.

VI. CONCLUSION

Where academics and practitioners have failed to come up with acceptable innovative alternatives to transfer pricing, the ALS remains as the cornerstone of the international tax regime on controlled transactions. The recent developments with regard to transfer pricing have exposed how harmful it may be to maintain the ALS solely in speech. Such distortion may lead to an allocation of taxing rights that significantly depart from what Contracting States have actually agreed when signing a tax convention. It is clear that ambulatory interpretation that envisage consensus where only struggle can be found lack legitimacy. The agreement supposed by the OECD cannot be achieved by interpretation.

The original intent of transfer pricing legislation and, as a consequence, of the application of the ALS, must be preserved. As argued, transfer pricing rules are intended to determine the entities’ taxable (market) income according to their ability-to-

pay, and the amendments to the OECD Guidelines proposed in the BEPS Project go far beyond such determination.

In his report, Mitchell Carroll made a strongly rhetorical question to build an argument in favor of the ALS. Whilst the question was mainly an argument against the FA, it can be reproduced generally with regard to any and every consensual approach: “[w]ill countries in which profits have clearly accrued agree to giving up a part or all of such profits as a result of an apportionment of the total net income or loss of the enterprise?”

If at that time, “[t]he great majority of administrations have definitely indicated that they would not”, there are reasons to believe that BEPS project aims at having this answer to be changed. Firstly because, by subscribing the current OECD proposals in the BEPS project, many States are already agreeing to giving up tax revenues without any support on tax conventions. The content currently attributed to the ALS in OECD reports goes far beyond the original intent of transfer pricing legislation and there is no reason to believe that States had such meaning in mind when signing tax treaties. Specifically, the late OECD proposals regarding synergy rents and intangibles are not supported by the ALS. On the contrary, they significantly deviate from merely determining what independent parties would have done.

The RFM, as proposed in this article, is a practicable ALS-based alternative, which may solve several of the feasibility problems addressed. Moreover, from a global perspective, which must include the realities of developing countries, RFM implies legal certainty, which is essential for promoting foreign direct investment. The theoretical framework provided is intended to create a path for further ALS-based alternatives to transfer pricing methods, taking into account the diversity of interests and level of development observed among States in the current international scenario.

After all, from a taxpayer perspective, the issue of the fairness of the allocation of tax revenues between States is mostly irrelevant. The main concern of the taxpayer is certainty. In the struggle between States for tax revenue, the interests of taxpayers are the most sacrificed. Due to the lack of a solution to the issue of inclusion of profits under Article 9(1), if the States disagree, the taxpayer is the one to suffer the consequences.

It is important to note that RFM, as proposed in this article, derives from the Brazilian practice, but this does not mean that the author subscribes the present Brazilian experience. Accordingly, the issues of rebuttable presumptions and the reasonability of the fixed margins still cannot be seen as a standard in that country. Tax authorities are still very reluctant to discuss reasonable margins, which would be different from the ones determined by law. However, when one considers the initial rejection to all solutions beyond the OECD Guidelines, it is relevant to note that the Brazilian experience has shown that the ALS could be interpreted in a different manner, which could probably offer interesting results. The mere fact that the OECD has been more flexible concerning to non-orthodox standards (consider the adoption of safe-harbors) may indicate that alternatives may be considered.

This article does not argue that reform in present transfer pricing standards is unnecessary, but ambulatory interpretation, mainly in this aggressive form intended by the BEPS Project, is certainly not a desirable proceeding to promote structural
modifications on the international tax regimes adopted throughout the Globe. This article has shown that although ALS may have some failures, the alternatives proposed within the BEPS initiative do not seem to reach better results and would, moreover, require a consensus which does not seem to be possible in the near future. It is true that transfer pricing should be evaluated beyond the OECD Guidelines, but one should consider that also international taxation as a whole must find its legitimacy beyond the OECD box. A sincere evaluation of the justice of the current international tax regime can only be carried out if the interests of non-OECD countries are actually taken into account. The addition of a G20 label in the BEPS Project has contributed very little in terms of promoting such inclusion.