

The Arm's Length Principle After BEPS and the Pillars

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Introduction

- Pressures on the ALP
- BEPS successes and failures in responding to these pressures
- Post-BEPS developments in government thinking
- Inventing a hybrid system of income attribution
- What next?

- Major themes
 - Perceptions of the ALP have changed
 - But it's not dead yet
 - So what now – can a hybrid (ALP / market jurisdiction override) system be made to work?

Pressures on the ALP

- Mobile income, mobile assets, mobile risks lead to low effective tax rates
 - ALP is part of the problem
 - ALP facilitates (or at least does not prevent) income mobility
 - Two aspects – MNE gaming and tax competition by states
- Complexity
- Physical presence-based nexus perceived to be inadequate in a changing economy
- Uncertainty is pervasive due to complexity and lack of government consensus on application of ALP

BEPS Successes and Failures

- Successes
 - Reporting and transparency
 - Clearer rules on risk and intangibles
- Shortcomings
 - Increased complexity
 - Governments generally agree BEPS rules do not stop income shifting even with improved reporting and transparency
 - Failure to gain agreement to backstop ALP with special measures
 - Role of capital not adequately clarified
 - Tax competition persists and undermines appropriate income attribution among countries
- Continuing questions as to whether the ALP is fit for purpose

Post-BEPS Changes in Thinking

- Need to go beyond ALP
- DSTs put pressure on US tech sector
- US tax reform opens door to US considering ALP alternatives
- Low effective tax rates persist and a belief grows that low tax rates will continue to persist without major agreed systemic change addressing income allocation and tax competition
- But importantly, broad unwillingness to dispense with the ALP

G20 / Inclusive Framework Agreement

- Hybrid system of income attribution
 - ALP the base case
 - Supplemented with formulary override for large, profitable companies
 - Two different tax bases, two different allocation methodologies, combined to achieve one result – though the integration rules are still a work in progress
 - Removal of DSTs and improved / streamlined dispute resolution key parts of the deal
- Paired with 15 % minimum tax (Pillar 2)
- Integrating ALP and formulary approaches is a work in progress
- Simplification of distribution and manufacturing returns also a work in progress – Amount B

What Next

- Can this kind of hybrid income allocation system be stable?
 - Massive technical challenges with integration of two systems, safe harbours, source rules double tax relief and dispute resolution
 - The hybrid system does not solve the complexity problem
 - Has the feel of a temporary way station
- Can current ALP issues be addressed while attention is focused on getting the new system up and running?
- If the ALP can be fixed, why do we need Pillar 1?
- But if problems with the ALP are intractable, why keep the ALP at the center of the income attribution process?
- Is the course of travel away from the ALP?