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THE LEGAL NATURE OF CORPORATE GROUPS' ENTITIES AND THE FUTURE OF ARM'S LENGTH PRINCIPLE AND TRANSFER PRICING

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Abstract

The search for an effective taxation of business income derived from the activities of multinational corporate groups is one of the main challenges of the current international tax system, which is built around the idea that related parties should carry economic relations as if they were independent, observing market conditions and the arm's length principle. This background is based on the 'entity approach', in corporate law terms, but does not seem to fit the hardly argued consensus that the global and digital economy is characterized by highly integrated and widespread groups, acting as one, thus fitting the notion of the 'enterprise approach'. This dichotomy found even more practical repercussions, in the field of international taxation, since the development of the work carried out by the OECD in 'taxing the digital economy' and the consequent discussions on new allocation nexus, differently than transfer pricing and arm's length principle, and moving towards a practical application of the 'enterprise approach'. The paper presents an overview on both the theoretical and practical implications of an adoption of each of the approaches, discusses the problems found at current OECD proposals and presents the outlines for an alternative solution to this dichotomy in the field of international taxation.

Purpose – The paper aims to identify both the theoretical background and the practical implications of the legal definition of entities inside corporate groups to the ongoing discussions on the redefinition of business income tax rules applicable to intra-group cross border activities. By doing so, the paper has the purpose to introduce the importance of such a discussion as a backbone for any new nexus to be advocated by the OECD and other international players in terms of designing a modified international tax system.

Design/methodology/approach – The research is based on a multidisciplinary and comparative methodology. Firstly, the paper should discuss concepts under the umbrella of corporate law and some of its founding principles, in order to apply these concepts to the scenario of international taxation, not only in terms of legal implications, but also minding issues related to tax policy. On the other hand, the comparative methodology is adopted when confronting current international standards to the recent OECD proposals to redefine the international tax system.

Finding – The paper represents the current state of development of a work in progress, which should culminate in a chapter of the author's doctoral thesis. Therefore, the findings presented at this paper should not be read as final. Nevertheless, based on the current progress of the research, the paper presents the outermost practical importance in the definition of a legal nature for corporate groups when designing new allocation nexus for business income derived from the international activities of such groups. The research was also able to find that the current OECD proposals, by unclearly mixing both the entity approach and the enterprise approach, should be more carefully and clearly developed. Some important aspects, as the outline of a solution, are also presented as findings of the paper.

Research limitations/implications – It is recognized that the definition of the legal nature of corporate groups have significant impact in several legal fields, as, for example, in terms of insolvency law. It is not under the scope of this paper to discuss the implications of the definition of the legal nature of corporate groups outside the boundaries of international taxation. The issues discussed in relation to liabilities, for example, will not be analyzed under the lights of other kinds of liabilities rather than the fiscal ones.

Practical implications – The paper is aimed to have a practical implication on the current discussions, led by the OECD, in terms of the redefinition of the allocation nexus for cross border business income taxation, especially under its recently published ‘unified approach’.

Originality/Value – The determination of the legal nature of corporate groups, although recognized in the paper as the backbone for the ongoing discussions on the relocation of taxing rights among jurisdictions where multinational corporate groups operate, has not yet been sufficiently tackled by academics in the field of international taxation. Most of the research published focus on the frames of corporate law and does not specifically address international taxation issues. This paper brings the outlines of an original solution to international taxation challenges, based on a proper analysis of the legal nature of corporate groups.

Keywords: Corporate Groups; International Taxation; Arm’s Length Principle; Entity Approach; Enterprise Approach.

Research type: viewpoint

JEL classification: K34.

Introduction

In 2016, the EU Commission issued a decision against *Apple* related to ‘abusive’ tax planning schemes which lead *Apple* to avoid paying its ‘fair share’ of business income tax in the Republic of Ireland between the years of 1991 and 2014 (European Commission, 2016, §39). It did not take long until the *Apple* case reached the headlines and, thus, the interest of a public far beyond tax scholars, practitioners, and policy makers. *Apple* is, perhaps, the most recalled example among several others that were exposed by the media in the last decade, whose list includes (but is certainly not limited to) *Starbucks*, *Amazon*, *Google*, etc.

What the broader public may not question is ‘what’ is *Apple*. Although perceived as a single operating brand, *Apple* is a fairly large multinational corporate group, whose structure comprises companies located all over the world. *Apple* is, in fact, *Apple Sales International*, *Apple Operations Europe*, *Apple Inc.*… Generally speaking, *Apple* can be considered a group, which operates under a common public *persona* (Blumberg, 1990, 344).

This paper, as a work in progress, aims at being a provocation to the discussion on the importance of a clearer determination of the legal nature of (multinational) corporate groups’ entities for the purpose of (re)understanding were the profits they realize should be allocated and, consequently, taxed. In the *Apple* case, for example, the efforts of such a study should be able to contribute to revisiting the question of ‘what is the nature of *Apple Sales International, Apple Operations Europe, Apple Inc.…*’, the nature of their relations and how they allocate profits and losses among them.

The need to actually revisit this question is based on the common understanding that the current international tax system, grounded on the entity approach, with the ‘view of each corporation as a separate legal entity, irrespective of its interrelationships with its affiliated corporations’ (Blumberg, 1990, 285) is problematic, not in line with the contemporary economic reality and, indeed, contributes to the raise of cases such as our *Apple*.

The on-growing importance of highly fragmented groups, the far greater mobility in the production factors and a heavier reliance on intangibles, facilitates the (re)allocation of operations in several jurisdictions, many times focusing on tax savings, having very low or even no physical presence at jurisdictions with which they hold a great economic connection (OECD, 2015, 16). We stand by the position that the current nexus of attribution of taxable profits, based on the entity approach and, consequently, the arm's length principle and on the rules on transfer pricing, as they stand today, is not able to follow these changes.

Besides several media reports on multinational corporate groups not paying their 'fair share' of taxes (whatever this expression may mean), other important elements contribute with the need to rethink the current system, such as the increasing tax uncertainty for both tax administrations and taxpayers and the desire to realign taxation with real economic activity. These efforts have been led by the work carried out by the OECD, especially in the post-BEPS (or BEPS 2.0) phase and with a group of experts at the task force on the digital economy.[1]

In a nutshell, we argue that the first step to that redesign effort should be a clear (re)definition of the legal nature of these groups, through a clear definition of the legal nature of the entities that comprise them. Only with such a defined background the new nexus rules (especially based on the OECD Pillar I 'unified approach' proposal)[2] will be theoretically and practically applicable (in other words: feasible).

1. Entity and enterprise approaches in current international tax law system

The regulation of corporate groups in the various jurisdictions is currently based on three main models. Those in which corporate groups are regulated by *general* civil and/or corporate norms, those in which there are *specific group regulations* (with the German *Konzernrecht* as the main example) and those with *specific provisions to various fields of law*, where taxation (and our study) fits (Hopt, 2015, 8-12). Usually, also in agreement with Hopt's explanations, the latter is combined with either the first or the second.

We will focus our studies on the third group, and it is still not under the scope of this paper to have a position defending if the rules on this third group should be 'harmonized' with the first or the second. In other words, it is outside of our scope to debate whether the thought to be applied for tax purposes should be extended to the other 'realms'.

Regardless of the model chosen, nevertheless, the nature of a corporate group can be generally categorized by the *entity approach* or the *enterprise approach*. Firstly, the entity theory of the legal

[1] The outlines of the mentioned work can be followed at: https://www.oecd.org/tax/beps/beps-actions/action1/
[2] *See*: OECD. Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint. OECD Publications, Paris (2020).

nature of corporate groups argues that a corporate group is composed by several independent units, as already advanced at the introduction of this paper.

This theory is strongly present at the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines) (OECD, 2017), last updated in 2017, as well as in the OECD Model Tax Convention on Income and on Capital, also from 2017 (OECD, 2017). The last update of the Guidelines, although presenting the outcomes of the BEPS project, does not account for the work which is been currently carried out by the task force on the digital economy and, namely, the 'unified approach' Pillar I expected outcomes.

Currently, for the purpose of the rules on the attribution of taxable profits among related entities, *Apple Sales International, Apple Operations Europe, Apple Inc.…* should be perceived as independent companies, whose operations should be evaluated as if performed in market conditions, thus emerging the arm's length principle and the rules on transfer pricing as they stand today. What was once an unquestionable effective perception is certainly, as already mentioned, not responding as effectively to the business models in a digital, integrated, and global economy.

In the context of the digital economy, several group related companies perform transactions that would not make sense in a 'free-market scenario'. This leads to practical difficulties in developing benchmark/comparability analysis based on the arm's length principle and it has been argued, also in the case law of the Court of Justice of the European Union, for example, that it is possible for related enterprises to actually enter commercially valid and justifiable transactions even outside the boundaries of the arm's length.[3] Following that line of thought, we do believe that the mere participation in a group and the goal to make the best (*commercially*) for that group as a whole could lead the way for a valid economic reason at non-arm's length in some transactions.

According to the preface of the Guidelines, OECD member countries have decided upon the adoption of a separate entity approach (entity theory) as it would be, in the wording of the Organization, 'the most reasonable means for achieving equitable results and minimizing the risk of unrelieved double taxation' (OECD, 2017). Only four years later (we would even say three, since the publication of the blueprints of Pillar I proposal happened in 2020) the OECD seems to have changed this perception and we are curious to see how the wording would be at the next update of the Guidelines, expected to be released in 2022[4]. *More on that on the following Chapter*.

In an opposite direction from the entity view, the enterprise theory defends that two or more separate, but affiliated corporations, would act as a single unit, at least for the purpose of certain legal fields or situation (Blumberg, 1990, 329).

[3] *See, for example*: ECJ. Hornbach-Baumarkt AG v. Finanzamt Landau (C-382/16): §51-54.
[4] This information was already released during public speeches from members of the OECD and is also available at the following link: https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm

Although the not very abundant body of studies from international tax studious tends to focus on the question of the nature of corporate groups' entities in terms of transfer pricing issues or, more broadly, in terms of allocation nexus, we realized that this problem retains its importance also in other fields of international taxation, in which different solutions/approaches can be found, in which one or the other theory is applied, adding complexity and, again, uncertainty to the subject, as the nature of the groups, *even that only for tax purposes*, can differ depending on the specific rule/situation.

As mentioned, the entity theory is now applicable in terms of transfer pricing. On the other hand, this does not seem to be the case for cross-border loss reliefs rules. Another interesting example where it is arguable that the enterprise theory is taking primacy is in relation to controlled foreign company (CFC) rules. There are certainly more 'branches' of international tax law where we can find such a discussion but let us limit ourselves to develop more on the nexus rules.

At this point, it is worthy to highlight that both the views upon the entity approach and the enterprise approach are extracted from the studies of corporate law specialists as the subject is not properly studied with the focus on international taxation issues. In this regard, several of the sources researched focus their discussions on purely corporate law consequences, especially connected to agency problems and discussions around independent legal personality, duties of management, integrity of corporate capital and protection of shareholders, for example (Cahn, A., & Donald, D.C., 2018, 832). It is not under the scope of this working paper to deeply analyze these sorts of consequences.

Although we argue in favor of a more uniform approach to the legal nature of corporate groups' entities in the several branches of international tax law (further studies on the feasibility of such an idea should undoubtably be carried out), it is not under the epistemological limitation of this paper to ascertain if a single nature should be broadly adopted for issues related to 'purely' company law and to those connected to international taxation, due to the impossibility of this conclusion at our current stage of research.

Our following comments, therefore, will focus exclusively on the consequences of the future adoption of one or another theory for the matters of international tax law, and, more specifically, to the discussions on the reallocation of taxing rights, under the work led by the OECD.

2. OECD task force on the digital economy and the future of arm's length principle, transfer pricing and the entity approach

The publication of the Final Report on BEPS Action 1 (OECD, 2015) was not able to deliver an applicable solution to the tax challenges of the digital economy. We would even say that, given

the fact that transfer pricing (Actions 8 to 10) was the main focus of the BEPS project, the project was not able to present the expected results back in 2015 and, therefore, the G20 renewed the mandate for the task force on the digital economy to conduct further work in the search for a 'consensus-based solution', which started to move away from transfer pricing and, as a consequence, from the very core of the BEPS project.

This work culminated in the presentation of two sets of solutions, divided into Pillar I (upon which our paper directs its attention) and Pillar II. The first relates to the redesign of the allocation nexus, while the later deals with a minimum global taxation.

Pillar I work is built around the idea that the current rules lead to an increasing legal uncertainty and to the raising of tax disputes, increasing the costs of doing cross-border business as well as of tax administrations, beyond increasing tax avoidance possibilities. Originally, this Pillar presented three main paths of solutions ('user participation'; 'marketing intangibles' and 'significant economic presence') (OECD, 2019) that culminated, a few months later, in the so-called 'unified approach' (OECD, 2019). The presentation of a 'consensus-based solution', expected to happen in 2020, was postponed due to the Covid-19 pandemic, but, still, a Blueprint document was published in October 2020 (OECD, 2020).[5]

These new Blueprints seem to recognize the existence of more group synergies, characteristic of the global and digital economy and considers the automated digital services and the consumer facing businesses (in principle, the businesses in-scope of the new nexus rules) as the tip of the iceberg from an entire group or a group business line operation that is not currently adequately taxed in the market or user jurisdiction. It also seems to focus more on the idea of a destination-based taxation rather than using the vague idea of value creation, more highlighted on previous OECD documents (Brokelind, 2021, 2).

Therefore, we can start to identify the wish to implement an enterprise view, as there is the prevision of allocation of a residual profit (so called 'Amount A') to be calculated given the **global** (or, at least, from a certain geographic area) **consolidated group** (or business line) **revenue**. The group is, therefore, seeing as a more indissociable structure. As mentioned in Chapter 1 above, the OECD now brings the enterprise theory, not acknowledged in the 2017 Guidelines.

The question here is that the new proposal mixes the moving towards an enterprise theory application, with the aforementioned 'Amount A', with the arm's length principle, as there is an 'Amount B', which basically functions as an attempt to slightly simplify the current transfer pricing

[5] For a practical overview on the Blueprints as well as on the development of the work carried out by OECD's task force on the digital economy, see: Greil, S. & Eisgruber, T. Taxing the Digital Economy: A Case Study on the Unified Approach. *Intertax*. 49 (01): 53-70.

rules and to limit it to simpler (more standard) activities, called as baseline distribution and marketing activities.

It is, therefore, a shift from an entity-oriented approach to a *more* enterprise-oriented solution, but in a much more *mixed* way. In theoretical terms, it does not seem to be a consistent approach, as it does not have a consistent departing point. In practical terms, it is arguable if it could lead to a more sustainable share of taxing rights and, consequently, of taxing revenues, nevertheless, the technicalities on which the work is structured seems to add layers of complexity to an already fairly complex system (Pistone, Nogueira, Andrade, Turina, 2020, 2), increasing tax uncertainty, even though the political message behind the work is the flag of tax *certainty*. This view is also shared by Ana Paula Dourado (Dourado, 2021, 6).

A way to perhaps mitigate this theoretical 'deficiency' would be to restructure 'Amount B'. The characterization of this amount, we have to highlight, is still pending further development by the OECD, as its broadness is a big political discussion between market (source) and residence countries (respectively capital importing and capital exporting countries).

Nevertheless, we aim at further studying the possibility of the calculation of the 'Amount B' based upon the classic elements of transfer pricing (functions, risks, and assets) but without links to the arm's length principle. As recognized by Dykes and Keegan, the search for simplicity in 'Amount B' tends to be difficulted by the wish to align it with the arm's length principle (Dykes & Keegan, 2021, 18). As already mentioned, it is clear that more and more transactions conducted by multinational groups of companies do not make sense to be conducted by independent parties and, thus, would not be effectively evaluated trough the arm's length principle and comparative analysis.

Last but not least, the moving away from the arm's length idea would contribute to the alignment of the treatment of both Amounts A and B to a more solid notion of the enterprise approach to related group companies. The design of such an idea, which would probably lead to the abandonment of benchmarking studies and walk towards the use of more formulas (perhaps indirectly been helpful in terms of the *quest* to tax certainty) will not fall under the scope of this paper.

Another *mixing* issue, which would probably be harder to solve, lies on the fact that the enterprise theory would only be applicable to *certain* groups, only when they have in-scope business activities. Besides raising the question of ring-fencing the digital economy (more connected to the business lines in question) it also seems to use the business lines as a determining factor to define the nature of corporate groups' entities, not its synergies, legal or *de facto* control or other more suitable elements. In other words, groups with in-scope business would be treated based on the enterprise theory, while groups with out-of-scope activities would still be treated based on the entity approach.

In a nutshell, the theoretical structure of the new nexus rules proposed by the OECD appears to be fragile, which compromises the building of such a solution. Of course, the solution to this fragility is most certainly not an easy one and we do not intend to solve all of it. *For now*.

3. The outlines of a new idea (which way forward?)

As recognized by the OECD, any new proposal that wishes to achieve significant global impact must rely on a broad adoption by the international community, entailing, therefore, a great measure of harmonization. This is probably the main (or, at least, one of the main) difficulties as it depends on the coordination of several different tax policies, based on the diverging interests of the jurisdictions involved in the OECD Inclusive Framework[6]. This harmonization is fundamental in terms of the feasibility of the changes to be implemented.

Therefore, a great deal of agreement should be reached since the first step towards the design of new allocation nexus: a broadly accepted determination of which entities would qualify as parts of the group. This is a very important step and, currently, a very problematic one, especially when dealing with *multinational* corporate groups. Ideally, the criteria should be as broadly adopted as possible, and should account for both legal and factual relationships. As for the first, a given percentual of controlled voting shares could be an interesting departing point, as of common ownership determining the existence of horizontal relations as well. In terms of *de facto* control, the criteria would necessarily have to be broader and more connected to each case.

As mentioned in Chapter 2 above, the Pillar I proposal ends up using the business lines as a determination factor for the nature of the corporate groups' entities, which does not seem to be a valid parameter. To solve that problem, as we have already anticipated, we would suggest that both Amounts A and B to be based on an enterprise approach, following the qualification parameters set above. Therefore, the idea is that whenever a set of companies would be considered as a group, regardless of if they operate under in or out-of-scope business, they will be treated based on the enterprise approach.

Of course, there is always the difficulty in determining if the newly adopted criteria would be applicable regarding different specific rules besides the allocation nexus (i.e., cross-border loss reliefs or controlled foreign company rules) which may require the application of different rules or different threshold of participation, for example. This step does not properly contribute to the arguments in favor either of the entity or the enterprise theory, but delineates the companies that, in practice, would be affected by one of these theories. Nowadays, a particular set of companies may be considered to be a group for transfer pricing requirements, but not for the application of CFC

[6] The list of the members of the Inclusive Framework can be found at: https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf

rules, for example. In a broader perspective, this same set of companies may be considered as a group for matters of company law or accounting, but not for tax law purposes.

Moving forward, we highlight that the existence of internal group conflicts (or agency problems) should not be, *per se*, a reason to exclude the adoption of the enterprise theory. This is easily verifiable when realizing that even a single company has internal conflicts which does not put in check its perception as a unit. We also do not agree with the idea encapsulated at the Guidelines that the adoption of the entity theory would be better suitable to avoid double taxation when compared to the enterprise view. The on-growing measures on administrative assistance and exchange of information will make it easier for countries to monitor where (and if) taxes are being paid and the development of allocation formulas should help reducing tax disputes.

On the other hand, we acknowledge that there should be limits to the adoption of this theory, otherwise, it would be impossible to share taxing rights and all the profit would ultimately be taxed at the level of the parent company, which could be established in a no or low tax jurisdiction. Moreover, countries are not willing to give up on national business income taxes and, consequently, there should be practical rules determining where each portion of the profits of a multinational group should be taxed. This limitation would work as a way to prevent groups from ultimately choosing where to be taxed by simply choosing where to set the parent company. The need to maintain a balanced allocation of taxing rights is the underlying justification of such a limitation and has also been largely defended by the European Court of Justice, for example.[7]

These rules will most certainly need to account for the different entities' participation in the generation of the taxable profits in different jurisdictions. The use of elements already existing under transfer pricing rules (functions, risks, and assets), as already mentioned, could serve as a base for the elaboration of the splitting formulas.

This is a limitation on the enterprise theory but should not be mistakenly confused with an adoption of the entity view. Here, the contribution of each part of the total (parts of the group) should be taxed where the contribution takes places. Again, the question on how to determine this location is beyond the scope of this paper and deserves a study (*several studies*) on its own.

4. Conclusions

In a nutshell, we agree with the fact that the entity approach is no longer in line with the global business reality based on the on-growing importance of multinational corporate groups operating in a highly integrated way. This seems to be a broad consensus when talking specifically about allocation nexus for taxable profits and taxing rights.

[7] *See, for example*: ECJ. Société de Gestion Industrielle v. Etat belge (C-311/08): §63; ECJ. Hornbach-Baumarkt AG v. Finanzamt Landau (C-382/16): §44.

On the other hand, we take from the studies carried out so far that, besides having the current application of the entity approach in terms of transfer pricing rules and the arm's length principle, there is not a clear definition of the legal nature of multinational corporate groups' entities broadly applicable in international tax law. The OECD 'unified approach' solution proposed under Pillar I, although a very important step towards facing the problem, brought that unclarity also to the allocation nexus discussion.

As developed throughout the paper, we are in favor of the need to redesign the nexus rules for the international tax system to be more in line with the new business models and, consequently, with the new economic reality. The enterprise approach appears to be the way forward, nevertheless, OECD's redesigning effort, as it is currently built, adds new layers of complexity and legal uncertainty. The failure to clearly exploring (and delineating) the legal nature of corporate groups' entities is the starting point of the problem.

If to leave our reader with one final idea is that, in case the seriousness of this issue is not considered by the OECD, the Pillar I proposal under the 'unified approach' tends to provide for a deficient solution, theoretically fragile, complex and questionable. With higher complexity, uncertainties, more will be the opportunities for aggressive tax planning strategies to be put forward and more *Apple* cases will reach the headlines. The solution needs to be 'principled-oriented' and not merely 'result-oriented' with a short-term view.

On the other hand, a successful implementation of new rules could ultimately lead to a broad redistribution of taxable profits and taxing rights to market countries, but also to the recapture of what is now stateless income, both by reason of tax avoidance strategies or simply because of a unharmonized 'race to the bottom' of tax rates in the context of investment attraction or maintenance, as we have already discussed elsewhere (Schmitz, 2019, 7-8).

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