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Simplification in Transfer Pricing: A Plea for the Enactment of Rebuttable Predetermined Margins and Methods Within Developing Countries

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Simplification in Transfer Pricing: A Plea for the Enactment of Rebuttable Predetermined Margins and Methods Within Developing Countries

by

*Aitor Navarro**

Abstract

It is the aim of this contribution to sustain that, despite the inherent complexity that the enforcement of the arm's length rationale entails, it is feasible—and desirable—to introduce simplification measures without abandoning this worldwide accepted standard, especially in the context of developing countries and despite reticence shown by international organizations such as the OECD. Complexity in transfer pricing erodes fairness and equity and promotes profit shifting, which paradoxically constitutes the opposite outcome that this set of rules wants to achieve. This is the reason why it is urgent to propose and encourage the adoption of a means to neutralize unnecessary complexity in this field. The adoption of rebuttable predetermined margins and/or methods is proposed as the best solution in a context in which policymakers want to keep the arm's length rationale intact. Also, even despite its shortcomings, irrebuttable predetermined safe harbors should be considered potentially feasible and a valid policy option.

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I. Introduction 756
II. The Unnecessary Complexity of Transfer Pricing Rules Based on the Arm's Length Principle Should Be Tackled 759
III. Means to Implement Simplification in Transfer Pricing 775
A. Measures Facilitating the Application of Transfer Pricing Rules Do Not Necessarily Entail Simplification 776
B. Rebuttable Presumptions Based on Predetermined Margins and/or Methods. An Arm's Length Compliant Approach to Simplification in Transfer Pricing 779
C. Irrebuttable References Should Also Be Explored as a Policy Option, Especially in Strategical Sectors 786
IV. Conclusion 788

I. Introduction

Almost every country in the world has adopted transfer pricing rules to allocate profits between related parties. The transfer pricing field is highly standardized, meaning that the different set of specific regulations of different jurisdictions is nearly identical. This is a logical outcome, as the standard upon which these rules are inspired is the same, namely the arm's length principle that imposes a fiction by which profits derived from controlled transactions are calculated, taking into account the outcome that unrelated parties would have agreed on under the same circumstances. Such an outcome is achieved through the performance of a comparability analysis. Departing from the transaction as it was structured by the related parties and taking into account all relevant facts and circumstances, comparable references have to be found so as to benchmark a specific pointer—be it the price of the transaction, gross margins, or net margins—to detect any possible deviation, and when necessary, perform an adjustment in the taxable base accordingly.

Notwithstanding, full parity could not be achieved even under faultless comparability, because compliance costs derived from the appropriate enforcement of transfer pricing rules will always pose a significant burden on controlled taxpayers vis-à-vis independent enterprises.[1] Indeed, one of the main shortcomings of current transfer

1. *See* Hubert Hamaekers, *Transfer Pricing and the Arm's Length Principle: History, Present Situation, Future*, 16 Skatterett 286, 297–98

pricing legislation is related to the complexity of its enforcement and the number of formal duties enterprises have to comply with.[2] Transfer pricing regulations are detailed and complex. These attributes tend to escalate against what would be desirable,[3] namely, a less disparate and easier to apply system.[4] Notwithstanding, complexity in transfer pricing is inherent to its mandate, which imposes a case-by-case analysis that

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(1998); Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the Transfer-Pricing Tax Puzzle*, 5 Tax Notes Int'l 399, 413 (Aug. 24, 1992) (criticizing in the early 90s the excessive compliance costs derived from transfer pricing rules). Nowadays, as complexity is even higher and documentation duties have been raised, such argument is even more meaningful. *See* Stefan Mayer, Formulary Apportionment for the Internal Market 16 (2009) (pointing out that many countries have not only tightened their documentation requirements but often also have added harsh penalties for non-compliance); Yariv Brauner, *Transfer Pricing in BEPS: First Round—Business Interests Win (But, Not in Knock-Out)*, 43 Intertax 72 (2015) (pointing out that inefficiencies derived from the arm's length principle are amplified by high compliance costs).

2. The author is well aware that the meaning of what is complex depends on the eye of the beholder and depends on the circumstances at the time of reviewing a set of rules and the reference one adopts to measure complexity. For instance, Pollock notes that the original Return of Annual Net Income of Individuals (Form 1040), put in service by the Bureau of Internal Revenue in 1913, was only three pages long, including a single page of instructions. Yet, at that time, it was perceived as far too complicated to be understood by the average taxpayer. *See* Sheldon D. Pollack, *Tax Complexity, Reform, and the Illusions of Tax Simplification*, 2 Geo. Mason Indep. L. Rev. 319, 322–23 (1994). That said, the present contribution aligns with the existing general consensus on qualifying transfer pricing rules as complex in their enforcement, especially in the context of developing countries.

3. Graeme Cooper, *Australia: Transfer Pricing*, *in* Tax Treaty Case Law Around the Globe 2012, at 115 (Eric C.C.M. Kemmeren et al. eds., 2013) (criticizing harshly the complexity surrounding transfer pricing when affirming that specialists seem to speak a rare dialect and use an arcane, completely fictitious and unconvincing methodology); *see also* Deloris R. Wright et al., *The BEPS Action 8 Final Report: Comments from Economists*, Int'l Transfer Pricing J., Mar./Apr. 2016, at 99.

4. See, in the same vein, Reuven S. Avi-Yonah et al., *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 Fla. Tax Rev. 497, 502 (2009); Glen Rectenwald, *A Proposed Framework for Resolving the Transfer Pricing Problem: Allocating the Tax Base of*

sometimes, due to the intricacy and/or uniqueness of certain transactions, is hard to comply with.

It is the aim of this contribution to assert that, despite the inherent complexity that the enforcement of the arm's length rationale entails, it is feasible—and desirable—to introduce simplification measures without abandoning this worldwide accepted standard. The discussion therefore will center on the superiority of the adoption of rules permitting the predetermination of margins or methods in an arm's length context versus a model in which only the comparability analysis is admitted as a means to achieve an arm's length result. Therefore, no reference will be made to the debate on the virtues of formulary apportionment as a means of allocating business revenue among related parties versus the arm's length principle, albeit arguments on the advantages derived from simplification may be extrapolated to this field, as one of the main improvements of formulaic solutions over the arm's length standard is simplicity. It is not the purpose of this contribution to tailor the specificities of optimal simplification measures but, instead, to provide arguments on the advantages of predetermined margins and methods and against reasons in favor of their dismissal.

The structure is as follows. In Part II, complexity in the field of tax law will be addressed to stress that the complexity of tax rules usually is proportional to the attainment of their goals, especially regarding fairness and equity. At first sight, the reason why transfer pricing rules are complex is related to the aim of treating controlled transactions as if they were performed by unrelated parties, thus guaranteeing the same tax treatment as the one resulting from market forces. Also, the fight against profit shifting is relevant in that regard. Notwithstanding, it will be shown that due to current complexity in the enforcement of these rules, the mentioned objectives are far from being achieved. Instead, a means to neutralize unnecessary complexity should be explored, especially in the context of developing countries and even despite reticence shown by the OECD. In Part III, specific measures will be analyzed. First, in Part III.A some measures will be discarded due to the fact that, despite facilitating the accomplishment of a thorough comparability analysis, some measures do not entail real simplification. Second, in Part III.B, simplification through the enactment of rebuttable presumptions based on predetermined margins and/or methods will

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Multinational Entities Based on Real Economic Indicators of Benefit and Burden, 23 Duke J. Comp. & Int'l L. 425, 440 (2012).

be praised as an arm's length compliant approach to simplification in transfer pricing. Third, in Part III.C, it will be shown that irrebuttable predetermined references are also a valid policy option in certain scenarios. In Part IV, conclusions to the aforementioned will be elaborated.

II. The Unnecessary Complexity of Transfer Pricing Rules Based on the Arm's Length Principle Should Be Tackled

Simplicity is considered to be one of the features of any well-built modern tax system. Ideally, rules should be easy to understand, both from the perspective of the scope and the resulting outcome, easy to comply with without entailing excessive costs, easy to administer, reasonably drafted to achieve a specific policy, and should avoid arbitrary distinctions.[5] The corollary of simplicity would be certainty, an overarching principle in any legal system based in the rule of law.[6] This is perhaps the main reason why simplification is regarded as self-evidently positive,[7] and, in principle, no one would advocate for complexity, yet complexity is one of the most salient features of tax systems, especially regarding corporate taxation, due to several reasons. Probably the most compelling one refers to the fact that, from a tax policy perspective, complexity is often the irremediable consequence of a better built tax system.[8] Usually, it will be necessary to adopt complex rules to take into account the particular circumstances of the taxpayer.[9] U.S. Senator Russell Long stated the idea in simple terms: "[T]he complexity in our code in the main is not there because of some mischief. Most of it is

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5. *See* Graeme S. Cooper, *Themes and Issues in Tax Simplification*, 10 Austl. Tax F. 417, 424 (1993) [hereinafter Cooper, *Themes and Issues*].

6. *See* Pollack, *supra* note 2, at 358; *see also* Sol Picciotto, *Problems of Transfer Pricing and Possibilities for Simplification* 7 (ICTD Working Paper No. 86, 2018), https://www.ictd.ac/publication/problems-of-transfer-pricing-and-possibilities-for-simplification/. More specifically, on the foundations of modern tax systems, Adam Smith considered that "a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty." Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations, bk. V, ch. II, ¶ II (1775).

7. *See* Cooper, *Themes and Issues*, *supra* note 5, at 421.

8. *See* Pollack, *supra* note 2, at 321.

9. Stanley S. Surrey & Gerard M. Brannon, *Simplification and Equity as Goals of Tax Policy*, 9 Wm. & Mary L. Rev. 915, 916 (1967).

there in the effort of Congress to do more perfect justice."[10] To put it another way, simplicity has to be weighted with other overarching principles in tax law that may entail complexity as, for instance, fairness and equity. Also, from the perspective of corporate taxes, complexity is considered as a consequence of constant developments in the way of performing business. As business transactions become more and more complex, so does tax law, although it is difficult to determine whether an inverse reasoning would better explain the issue (i.e., that business became complex due to ever-increasing regulations). At any rate, what seems clear is that such a spiral was also enhanced by the fact that tax law is often regarded as a policy instrument, entailing additional rules and nuances to be taken into account, such as targeted tax breaks, allowances, special sectorial regimes, and so on. On top of that, anti-abuse rules are constantly introduced to preserve the integrity and the attainment of the objectives of the tax system, the complexity of which is often quite remarkable, as it is the interaction between each other.

Undeniably, the aforementioned has a clear reflection in the very rationale of the existence of transfer pricing rules. Within corporate taxes, the assumption of the separate entity approach when calculating the taxable income of groups of enterprises demands the arm's length notion as an essential tool to preserve coherence.[11] This is because, in order to compare and equally tax income earned by controlled and uncontrolled entities, a criterion needs to be adopted so as to equate both scenarios. Here lies the importance of the arm's length standard, namely in its role as a tool to level the ability to pay shown by a group of enterprises with that of independent parties that interact within the market. Therefore, through transfer pricing adjustments, income is allocated among related entities as if they were independent parties conducting the same transaction in order to guarantee equality in tax treatment and

10. *Tax Reform Proposals—III: Hearing Before the S. Fin. Comm.*, 99th Cong. 53 (1985) (statement of Senator Russell Long; quoted in Pollack, *supra* note 2, at 321).

11. *See* Luís Eduardo Schoueri, *Arm's Length: Beyond the Guidelines of the OECD*, 69 Bull. for Int'l Tax'n, no. 12, 2015, at 690 [hereinafter Schoueri, *Arm's Length*]; *see also* Raffaele Petruzzi, *The Arm's Length Principle: Between Legal Fiction and Economic Reality*, *in* Transfer Pricing in a Post-BEPS World, at ch. 1 (M. Lang et al. eds., 2016).

a clear reflection of income, according to market parameters.[12] Also, from the side of inter-nation equity, the arm's length standard plays a major role, as it prevents controlled entities from arranging transactions to divert profits overseas, depriving the State in which the income was generated from taxing such income. Indeed, the origins of this standard reflect such a view. Specifically, U.S. legislative history shows that section 45 of the 1928 Revenue Act—one of the predecessors of current section 482 of the Internal Revenue Code—was drafted to fulfil a twofold aim, namely the proper allocation of income and the fight against tax evasion and avoidance.[13] Therefore, by allotting income to the involved parties and allocating taxing rights to the involved countries, transfer pricing rules are the corollary of horizontal equity and internation equity in corporate taxation.[14]

But complexity in transfer pricing comes at a cost, especially in the context of developing countries. Pretended refinements in equity and fairness in the context of the arm's length mandate entail an excessive compliance burden, in a manner that could be regarded as irrational from an efficiency viewpoint, both from the side of the taxpayer and assessment costs from the side of the tax administration,[15] which should not be underestimated in assessing the overall adequacy of this set of rules. It is well known that the source of complexity in transfer pricing derives from the fact that a thorough comparability analysis has to be conducted according to the circumstances of the case. In order to do so, it is necessary to: (1) perform a functional analysis to determine the characteristics of the parties, the transaction, and the circumstances surrounding it; (2) choose a valid comparable reference and a method

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12. *See* Schoueri, *Arm's Length*, *supra* note 11, at 695; *see also* Aitor Navarro, *The Arm's Length Standard and Tax Justice: Reflections on the Present and the Future of Transfer Pricing,* 10 World Tax J., no. 3, 2018, at 351, 355.

13. For specific references, see Aitor Navarro, Transactional Adjustments in Transfer Pricing § 1.4.1.1 (2018).

14. *See* Wolfgang Schön, *International Tax Coordination for a Second-Best World (Part III)*, 2 World Tax J., no. 3, 2010, at 227, 230; *see also* Alessandro Turina, *Back to Grass Roots: The Arm's Length Standard, Comparability and Transparency—Some Perspectives from the Emerging World*, 10 World Tax J., no. 2, 2018, at 295, 300.

15. *See* Reuven S. Avi-Yonah*, The Structure of International Taxation: A Proposal for Simplification*, 74 Tex. L. Rev. 1301 (1996); *see also* Michael C. Durst, *Making Transfer Pricing Work for Developing Countries*, 60 Tax Notes Int'l 851 (Dec. 13, 2010).

in accordance with the facts of the case and perform adjustments to improve accuracy as much as possible; and (3) determine the differences and perform a primary adjustment when necessary.[16] As it is logical, the difficulty of such a process will mainly depend on the transaction undertaken by the parties, as well as the availability and reliability of the information on comparable references. In addition, all of this analytical process has to be properly documented,[17] hence the issue is mainly an "administrability" one.[18]

This constitutes the essence of the realization of the arm's length principle but is also its main shortcoming.[19] Excessive complexity may end up generating apathy within taxpayers, generating at the end of the day situations that are defective or even noncompliant. Joseph Andrus, head of the OECD Transfer Pricing Unit in 2012, described it bluntly:

> [M]ost tax authorities report that the information provided in the typical transfer pricing study is highly uninformative, that such studies often bear a strong flavour of having been prepared by a second-year associate wielding a cookie cutter, and that the information provided is not at all adequate to form the basis for even an initial evaluation of whether expenditure of transfer pricing examination resources in a particular case may or may not be warranted.[20]

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16. *See* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ¶ 1.33 (2017), http://dx.doi.org/10.1787/tpg-2017-en [hereinafter *TPG 2017*]; U.N. Dep't of Int'l Econ & Soc. Affairs, U.N. Practical Manual on Transfer Pricing for Developing Countries ¶ B.2.1.1 (2017) [hereinafter U.N. 2017 PMTP].

17. The OECD adopts a three-tier approach consisting in the preparation of a master file, a local file, and a Country-by-Country (CBC) report. *TPG 2017*, *supra* note 16, ¶ 5.16; *see also* U.N. 2017 PMTP, *supra* note 16, ¶ B.1.6.5.

18. *See* Turina, *supra* note 14, at 298.

19. *See TPG 2017*, *supra* note 16, ¶ 4.127 ("Transfer pricing compliance and administration is often complex, time consuming and costly."); *see also* Patricia Hofmann & Nadine Riedel, *Transfer Pricing Regimes for Developing Countries*, 72 Bull. for Int'l Tax'n, no. 4/5, 2018, at 316, 317.

20. Joseph L. Andrus, *Tax Avoidance and Transfer Pricing*, 18 Asia-Pac. Tax Bull., no. 6, 2012, at 435, 436 [hereinafter Andrus, *Tax Avoidance and Transfer Pricing*].

This reality is diametrically opposite the one described in the most widely recognized set of international recommendations in transfer pricing, namely the OECD Transfer Pricing Guidelines, that promote an in-depth, extremely detailed and extensive analysis of each transaction undertaken by related parties. To expect such a level of exhaustiveness to be always achieved is being somewhat unaware of the fact that taxpayers cannot dedicate an unlimited amount of resources to complying with transfer pricing rules. On the other hand, administrative problems derived from the applicability of the arm's length principle impact more heavily within tax administration, due to the disadvantages of information asymmetry,[21] as the revenue authority perspective of a case depends on a first-hand basis on the documentation the taxpayer has prepared and thus on the information it discloses,[22] as well as its freedom to contractually allocate functions, assets, and risks.[23]

The existing complexity in transfer pricing may also be explained from a behavioral viewpoint. The perspective of tax rules as a game was explored by Pollock, who stressed that, as players fully learn the range of moves possible under the established rules, they become more and more sophisticated in their play. Then, the rules of the game also may be modified to counteract and balance the all increased level of skill.

As a result, the game itself becomes more and more complex and generates high entry barriers and institutionalization,[24] meaning that the more intricate the rules become, the higher the need for

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21. Picciotto, *supra* note 6, at 22.

22. *See TPG 2017*, *supra* note 16, ¶ 6.191; *see also* OECD, *BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles: Public Discussion Draft* ¶ 5 (2017), https://www.oecd.org/ctp/transfer-pricing/BEPS-implementation-guidance-on-hard-to-value-intangibles-discussion-draft.pdf [hereinafter *2018 Action 8*]; OECD, *Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles: Inclusive Framework on BEPS: Action 8*, at ¶ 5 (2018), http://www.oecd.org/tax/transfer-pricing/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf.

23. For instance, Richard J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 World Tax J., no. 3, 2010, at 291, 333 (warning about the freedom to contractually assign risk "at the stroke of a pen").

24. *See* Pollack, *supra* note 2, at 348.

professionals dedicated exclusively to the task of applying them,[25] as well as for institutions proposing regulations on the subject matter, which in turn generates more complexity. The outcome is that the winning players are those able to profit out of complexity, which in turn are those taxpayers that can afford to hire highly specialized experts. Indeed, the breadth of the arm's length mandate, the application of which depends on the circumstances of the case under scrutiny, may give rise to a grey area that entails a decisive advantage to large taxpayers conducting transactions in which a little range variation could result in significant tax savings.

Brauner emphasizes that transfer pricing rules provide taxpayers, who take transfer pricing seriously, the advantage of setting the rules of the game with the facts presented in the way they want them to be presented.[26] From that perspective, paradoxically, the arm's length standard may encourage profit shifting to low tax jurisdictions[27] by forcing

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25. Picciotto, *supra* note 6, at 23 (describing this phenomenon as an "arm's race in expertise" and quoting interesting examples to illustrate it).

26. *See* Yariv Brauner, *An International Tax Regime in Crystallization*, 56 Tax L. Rev. 259, 274 (2003); *see also* Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 Va. Tax Rev. 79, 158–59 (2008) [hereinafter Brauner, *Value in the Eye of the Beholder*]; J. Clifton Fleming, Jr. et al., *Worse than Exemption*, 59 Emory L.J. 79, 125 (2009) (stating that "the taxpayer possesses the facts necessary to evaluate the transfer pricing decision"). In the same vein, see Ilan Benshalom, *Rethinking the Source of the Arm's-Length Transfer Pricing Problem*, 32 Va. Tax Rev. 425, 427 (2013); Adam H. Rosenzweig, *Defining a Country's "Fair Share" of Taxes*, 42 Fla. St. Univ. L. Rev. 373, 384 (2015).

27. *See* Kerrie Sadiq, *The Traditional Rationale of the Arm's Length Approach to Transfer Pricing—Should the Separate Accounting Model Be Maintained for Modern Multinational Entities?*, 7 J. Austl. Tax'n 196, 200 (2004); *see also Draft Report on Tax Rulings and Other Measures Similar in Nature or Effect: Special Committee on Tax Rulings and Other Measures Similar in Nature or Effect*, § 16, 2015/2066(INI) (July 20, 2015), https://www.europarl.europa.eu/doceo/document/TAXE-PR-564938_EN.pdf (stating that 72% of profit shifting in the European Union is achieved through transfer pricing planning, in accordance with the E.U. Commission, as stated in *Commission Staff Working Document: Corporate Income Taxation in the European Union*, COM (2015) 302 final (June 17, 2015)); Reuven S. Avi-Yonah, Xilinx *and the Arm's-Length Standard*, 54 Tax Notes Int'l 859 (June 8, 2009); Vann, *supra* note 23, at 313.

the limits of acceptable prices in each stage of the analysis.[28] In other words, even when the arm's length principle is correctly enforced, there are significative options for profit shifting.[29] Despite the fact that transfer pricing is theoretically linked to the furtherance of fairness and equity in tax law, it is not any less true that a complex set of transfer pricing rules generates inequity, as those with resources to spend on bold tax advisors will be better positioned than the rest of the taxpayers, inasmuch as ambiguity may be exploited for their own advantage.[30]

Consequently, as a reaction to this reality, regulation proposals become more complex as they try to tackle such an outcome. An illustrative case is that of the recommendations posed by the OECD on the field of transfer pricing in the context of BEPS. The fact that the policy embedded in the BEPS project tries to curb—as its name indicates—base erosion and profit shifting, while maintaining the arm's length principle intact at the same time, generates frictions that produce noncoherent results.[31] Indeed, the inclusion of measures that are beyond the arm's length principle are a symptom of the erratic path the OECD has undertaken. Also, guidance that is apparently contrary to such standard, which was fostered in drafts, was later on removed. Multiple examples may be quoted (e.g., the economic ownership approach

28. *See* Brauner, *Value in the Eye of the Beholder*, *supra* note 26, at 161; *see also* Fleming, Jr. et al., *supra* note 26, at 126.

29. *See* Christian J. Bauer & Dominika Langenmayr, *Sorting into Outsourcing: Are Profits Taxed at a Gorilla's Arm's Length?*, 90 J. INT'L ECON. 326 (2013); *see also* Hofmann & Riedel, *supra* note 19, at 318.

30. *See* Cooper, *Themes and Issues*, *supra* note 5, at 427; *see also* Steve R. Johnson, *The E.L. Wiegand Lecture: Administrability-Based Tax Simplification*, 4 NEV. L.J. 573, 579 (2004); Jeremy J. Cape, *The Dream of Simplification*, 89 TAX NOTES INT'L 463, 464 (Jan. 29, 2018).

31. Probably the most blatant illustration of misunderstandings that may arise due to such a scenario would be the overreaching scope of the control over risk criterion within the new guidance on the subject matter. In this sense, the OECD proposes the disregard of contractual risk allocation within the facts assessment stage prior to the comparability analysis, albeit such an approach derives from a blatant recharacterization of the elements of the transaction in breach of the notion of exceptionality posed in guidance referred to that subject matter. *See* OECD, *Aligning Transfer Pricing Outcomes with Value Creation—Actions 8–10 Final Reports* ¶ 1.65 (2015), https://dx.doi.org/10.1787/9789264241244-en [hereinafter OECD, *Aligning Transfer Pricing Outcomes*]. *But cf. id.* ¶ 1.121.

included in the 2012 draft on intangibles,[32] guidance on recharacterization,[33] the proposal of special measures,[34] and so on). The point here is not to criticize the fact that all these measures were removed, because such reconsideration should be regarded as adequate in the first place. Notwithstanding, the proposal of measures that were later discarded alongside measures that were included in the final guidance of BEPS go beyond the arm's length principle, showing the difficulties of the "policy through interpretation" approach adopted by the OECD, which at the end of the day entails increased complexity.[35]

On the other hand, the uneven situation that transfer pricing rules generate does not affect taxpayers exclusively, but also tax administrations, as resources to manage efficiently and effectively the correct application of domestic regulations are usually scarce, and often tax officials lack skills needed to conduct proper transfer pricing assessments. Often, resources of large taxpayers dedicated to design an appropriate transfer pricing policy overcome those the tax administration may assign to assessment tasks, a fact that generates an imbalance in favor of the former.[36] This issue is even more severe in the framework of

32. *See* OECD, *Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions: 6 June to 14 Sept 2012*, at ¶¶ 35, 37 (2012), https://www.oecd.org/ctp/transfer-pricing/50526258.pdf.

33. *Cf.* OECD, *Aligning Transfer Pricing Outcomes*, *supra* note 31, § D.2; OECD, *Public Discussion Draft: BEPS Actions 8, 9 and 10: Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)* § D.4 (2014), https://www.oecd.org/ctp/transfer-pricing/discussion-draft-actions-8-9-10-chapter-1-TP-Guidelines-risk-recharacterisation-special-measures.pdf [hereinafter OECD, *BEPS Actions 8, 9 and 10*].

34. *See* OECD, *BEPS Actions 8, 9 and 10*, *supra* note 33.

35. *See* Richard S. Collier & Joseph L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS 262 (2017).

36. *See* Ilan Benshalom*, Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method*, 28 Va. Tax Rev. 619, 622 (2009); Johnson, *supra* note 30, at 583; *see also* Yariv Brauner*, Formula Based Transfer Pricing*, 42 Intertax 615, 626 (2014); Sandra Reid Robertson, *Transfer Pricing Solutions in the Global Economy*, 3 Ann. Survey Int'l & Comp. L. 177, 190 (1996) (pointing out rightfully that the erroneous enforcement of transfer pricing rules could be a double-edged sword: it may entail double taxation, but also non-taxation).

developing countries,[37] where data on comparables is scarce in comparison with other developed countries—where issues also arise in that regard—making this aspect a critical one because it impedes an adequate treatment of the comparability analysis,[38] which results in an increase of conflicts between taxpayers and tax administrations.[39]

This fact, without doubt, calls into question the suitability of the arm's length principle as an efficient mechanism to internationally allocate corporate income,[40] especially from the perspective of developing countries. The truth is that the rather abstract objectives of fairness

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37. *See also* Louis M. Kauder, *International Allocations of Income: Problems of Administration and Compliance*, 9 J. Int'l L. & Econ. 1, 45 (1974); Howard LaMont, *Multinational Enterprise, Transfer Pricing, and the 482 Mess*, 14 Colum. J. Transnat'l L. 383, 430 (1975) (reporting more than 40 years ago that the arm's length principle could be detrimental to the interests of developing countries).

38. *See* Joseph L. Andrus et al., *The Arm's-Length Principle and Developing Economies*, 20 Tax Mgmt. Transfer Pricing Rep. (BNA), no 12, Oct. 20, 2011, at 495; *see also* U.N. 2017 PMTP, *supra* note 16, ¶ 1.10.6 (sharing the existence of additional constraints to achieve an effective implementation of transfer pricing rules within developing countries are ascertained); Richard Collier & Nadine Riedel, *The OECD/G20 Base Erosion and Profit Shifting Initiative and Developing Countries*, 72 Bull. for Int'l Tax'n, no. 12, 2018, at 704, 706; Ednaldo Silva, *'Pygmalion' Comparables: Why Data from the 'Center' Does Not Apply for the 'Periphery,'* 23 Tax Mgmt. Transfer Pricing Rep. (BNA), no. 22, Mar. 19, 2015, at 1465. *Cf.* Jeffrey Owens, *Transfer Pricing and Treaties in a Changing World*, 57 Tax Notes Int'l 519, 520 (Feb. 8, 2010) (pointing out that it takes between 10 and 20 years to implement adequate transfer pricing rules in an OECD country, but encouraging developing countries to undertake the same path, as to "protecting their tax base while not hampering foreign direct investment and cross-border trade").

39. *See* Michael C. Durst, *Developing Country Taxation, Part VI: The Importance of Measuring the Effects of Transfer Pricing Reform*, 24 Tax Mgmt. Transfer Pricing Rep. (BNA), no. 3, June 11, 2015, at 168, 170. An intermediate solution proposed by certain Brazilian scholars would be the adoption of predetermined margins as safe harbors within the arm's length principle, in order to ease the burden of documentation which is inherent to current transfer pricing rules. Marcelo Ilarraz, *Drawing upon an Alternative Model for the Brazilian Transfer Pricing Experience: The OECD's Arm's Length Standard, Pre-Fixed Profit Margins or a Third Way?*, 2014 Brit. Tax Rev. 218, 232; Schoueri, *Arm's Length*, note 11, at 699–700.

40. *See* Hofmann & Riedel, *supra* note 19, at 317.

through equity and the prevention of profit shifting are certainly perverted by the described two-speed scenario, in which resourceful taxpayers have a clear advantage over others and over tax administrations with scarce resources to deal with transfer pricing complexity.[41] Indeed, equality and neutrality are inevitably sacrificed when a system is too complex.[42] If fairness is the final objective of transfer pricing legislation, not only the amount of tax, but also compliance costs are relevant. At this point, to question whether or not simplification measures should be introduced in transfer pricing is pointless. Rather, the discussion should center on which measures should be introduced to achieve simplification.[43]

Perhaps to advance in such a direction, it helps to ascertain that the very notion of income is not a concept derived from nature, but a conventional one. Taxation is not based on facts, but on an acceptable version of facts. Schoueri rightfully points out that the profit of a company is calculated by way of a number of accounting and tax conventions, which allow one to arrive at a profit that is sufficiently acceptable, but which is not scientifically verifiable.[44] For instance, rules on asset depreciation do not require taxpayers to hire an expert to determine with complete exactitude the grade of devaluation an asset has suffered due to its use. Instead, depreciation percentages are normally established. These percentages may not duly reflect the effective depreciation of a specific asset, but the legislator agreed that established margins are reasonable enough. The tradeoff that the depreciation rules make is for a fictitious but highly administrable system rather than a financially accurate but administratively difficult system.[45]

Another quite widespread example of simplification, promoted at an international level by the OECD with a high success rate, refers to

41. *See* Picciotto, *supra* note 6, at 6.

42. *See* Schoueri, *Arm's Length*, *supra* note 11, at 706; *see also* Cooper, *Themes and Issues*, *supra* note 5, at 426 (all referring to the tax system as a whole); John G. Head, *Tax Fairness Principles: A Conceptual, Historical and Practical Review*, 9 Austl. Tax F. 65 (1992); Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 Stan. L. Rev. 567 (1965).

43. Joseph Andrus, as Head of the Transfer Pricing Unit at the OECD, affirmed that "transfer pricing must get simpler if the current arm's length-based system is going to survive." Andrus, *Tax Avoidance and Transfer Pricing*, *supra* note 20, at 436.

44. *See* Schoueri, *Arm's Length*, *supra* note 11, at 697, 704.

45. *See* Rectenwald, *supra* note 4, at 440.

interest barrier rules[46] (i.e., a fixed ratio rule that limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest), taxes, depreciation, and amortization (EBITDA).[47] The key takeaway in this regard is that a fixed ratio rule is "relatively simple for companies to apply and tax administrations to administer,"[48] especially when compared with other alternatives such as interest limitations based on arm's length inquiries on the appropriate debt/equity ratio tailored in accordance with the circumstances of the company. It is remarkable that the OECD has been the main promoter of this simplified rule aimed at preventing base erosion and collection, while at the same time displaying significant objections.

Indeed, the OECD has shown an erratic stance on the matter of simplification in transfer pricing. Its traditional position has been to neglect the compatibility of safe harbors with the arm's length standard. In the 1995 Guidelines, the adoption of safe harbor measures was not recommended due to their potential inconsistency with the arm's length principle.[49] Notwithstanding, in a 2013 draft on the revised section on

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46. Just to mention some relevant examples, the 2017 U.S. tax reform amended I.R.C. § 163(j) to disallow a deduction for business interest when net business interest expense exceeds 30% of adjusted taxable income (Pub. L. 115-97, § 13301(a), 131 Stat. 2054 (2017)). It is relevant to note that an amendment to this rule was introduced in the legislative response to the COVID outbreak through the CARES Act, Pub. L. No. 116-136, 134 Stat. 281 (2020), allowing taxpayers for tax years beginning in 2019 or 2020 to raise the said limit to 50%. I.R.C. § 163(j)(10)(A). Taxpayers can also elect to calculate the interest limitation for 2020 using their 2019 adjusted taxable income as the relevant base. I.R.C. § 163(j)(10)(B). As regards the European Union, Member States are obliged to implement in their domestic legislation an interest barrier rule tailored in accordance with that of article 4 of the Anti-Tax Avoidance Directive (Council Directive 2016/1164, art. 4, 2016 O.J. (L 193) 1 (EU)).

47. *See* OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments: Action 4: 2015 Final Report* ¶ 23 (2015), https://doi.org/10.1787/9789264241176-en.

48. *Id.* ¶ 86.

49. OECD Comm. on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Draft Text of Part II)* ¶ 4.123, OCDE/GD(95)31 (1995), http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=OCDE/GD(95)31&docLanguage=En [hereinafter *TPG 1995*].

safe harbors of the Transfer Pricing Guidelines, the OECD affirmed that in the right circumstances, the use of bilateral and multilateral transfer pricing safe harbors should be encouraged.[50] The OECD even drafted sample MOUs to be used by Competent Authorities in negotiating bilateral safe harbors for common categories of transfer pricing cases involving low risk distribution functions, low risk manufacturing functions, and low risk research and development functions.[51] An example would be that of the agreement between the United States and Mexico regarding safe harbor profit ranges for maquiladora operations, effective January 1, 2000, making the maquiladora earn a taxable profit equal to the higher of 6.9% of the total value of the assets used in its operations, including fixed assets and inventories owned by the U.S. parent, or 6.5% of total expenses deductible by the maquiladora (labor, rent, and utilities) incurred in the operation.[52] While bilateral safe harbors negotiated between country competent authorities are to be preferred, potential alternatives to bilateral safe harbors, such as regionally developed safe harbors for regions that share common characteristics, may also assist.[53] That said, the strict limits and shortcomings noticed in every report the OECD has released on the subject matter, combined with the apathy of this international organization in promoting the adoption of safe harbors, is the main reason why this field remains strikingly underdeveloped.

Specifically, the OECD conducted a survey that showed that 33 of the 41 participating countries introduced some type of simplification measures, for a total of 69 measures, most of them related to exemptions for small and medium enterprises and small transactions, and from measures related to documentation,[54] hence not entailing simplification

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50. *See* OECD, *Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines* ¶ 4.128 (2013), https://www.oecd.org/ctp/transfer-pricing/Revised-Section-E-Safe-Harbours-TP-Guidelines.pdf; Thomas W. Giegerich, *Transfer Pricing Safe Harbors—An Idea Whose Time Has Come?*, 43 Int'l Tax J., Sept.-Oct. 2017, at 35, 40.

51. *TPG 2017*, *supra* note 16, at 449, Annex I to ch. 4.

52. *See* Giegerich, *supra* note 50, at 39.

53. *See* OECD, *Transfer Pricing Comparability Data and Developing Countries* ¶ 26 (2014), https://www.oecd.org/ctp/transfer-pricing/transfer-pricing-comparability-data-developing-countries.pdf.

54. *See* OECD, *Multi-Country Analysis of Existing Transfer Pricing Simplification Measures* (2012), http://www.oecd.org/tax/transfer-pricing/50517144.pdf; *see also* Picciotto, *supra* note 6, at 30.

at a conceptual level. Undeniably, despite the need for simplification in transfer pricing, few initiatives exist in this direction, if compared with the widespread adoption of the arm's length principle based on the comparability analysis across jurisdictions. Some of the first ones were included in the U.S. transfer pricing regulations,[55] such as those referring to interest rates for intercompany loans[56] and a "cost only" safe harbor permitting routine intercompany services to be performed without a profit markup.[57] Indeed, possibly the most widespread safe harbor rule refers to low-value intragroup services. In addition to the United States, countries such as Australia, Austria, Hungary, Japan, the Netherlands, New Zealand, Singapore, and Spain,[58] among others, have some sort of simplification measures relating to this field. Even the OECD is in favor of a simplified approach under which a cost plus 5% of profit margin is an adequate remuneration.[59]

The most successful measure adopted as a fixed margin that is blatantly contrary to arm's length outcomes is the so-called sixth method, entailing a deemed-date approach by enacting rules that disregard the agreements by the parties to fix a specific time reference from which the price will be ascertained.[60] Argentina was the first jurisdiction enacting such a rule, as the government was seeking to evaluate the sale of raw materials to related parties located in countries with lower tax rates.[61] It was then established that the highest price between that agreed by the

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55. *See* Patricia Gimbel Lewis, *Safe at Last? Transfer Pricing Safe Harbors on the Horizon*, 21 Tax Mgmt. Transfer Pricing Rep., no. 9, 2012, at 539, 541.

56. Reg. § 1.482–2(a)(2)(iii).

57. Reg. § 1.482–9(b).

58. *See* Ajit Kumar Jain, *Is It Time to Anchor Intra-Group Services in the Safe Harbour?*, 21 Int'l Transfer Pricing J., no. 6, 2014, at 432, 436.

59. *TPG 2017*, *supra* note 16, ¶ 7.61; OECD, *BEPS Action 10 Draft: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services* ¶ 7.57 (2014), https://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-low-value-adding-intra-group-services.pdf [hereinafter OECD, *2014 BEPS Action 10*] (explaining about a 2%–5% threshold was proposed and abandoned in favor of a fixed 5% margin); *see also* OECD, *Aligning Transfer Pricing Outcomes*, *supra* note 31, ¶ 7.61.

60. *See* U.N. 2017 PMTP, *supra* note 16, § B.3.4.2.

61. Alexandra Readhead, *Preventing Tax Base Erosion in Africa: A Regional Study of Transfer Pricing Challenges in the Mining Sector*, Nat.

related parties or the date of the shipment at the port of origin would be the one to be used for transfer pricing purposes.[62] The date of the arrival of the commodities at destination or the existence of intermediary transactions in which the commodity may be sold to other parties then becomes irrelevant. This way, the taxpayer would not be able anymore to select the most advantageous quoted price, and thus, options for transfer pricing planning were diminished. This measure was later adopted in other Latin American countries such as Bolivia, Brazil, Costa Rica, the Dominican Republic, Ecuador, Guatemala, Paraguay, Peru, and Uruguay[63]—some of these rules entail a modified version of the Argentinian one—as well as in certain African jurisdictions, such as Zambia.[64] This measure addresses the needs of a strategical sector within resource-rich developing countries, such a strategical need being a more important factor vis-à-vis the maintenance of the arm's length consensus.

India also adopted several safe harbor rules in 2013, with a view to minimizing litigation. Adopted measures refer to the provision of software development services, information technology enabled services, knowledge process outsourcing services, outbound intragroup loans, provision of corporate guarantees, R&D contract research referred to as software development, R&D services related to certain pharmaceutical drugs, and the manufacture and export of auto components.[65] References adopted are percentages calculated over costs, operating margins, or external public references such as the base rate of the State Bank of India in the case of intragroup loans.

Resource Governance Inst. 10 (July 2016), https://resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf.

62. Joel Cooper et al., World Bank GRP, Transfer Pricing and Developing Economies: A Handbook for Policy Makers and Practitioners 101 (2016).

63. See further information on the specificities of the rules enacted in each jurisdiction following the "sixth method" rationale. *Data Base on Transfer Pricing Rules and Practices in Latin American and Caribbean Countries*, CIAT, https://www.ciat.org/transfer-pricing/?lang=en (last visited Apr. 26, 2020).

64. *See* Readhead, *supra* note 61, at 16; *see also* Turina, *supra* note 14, at 326.

65. *See* Jain, *supra* note 58, at 433.

Only Brazil has adopted a comprehensive set of transfer pricing rules based on predetermined margins.[66] The transfer pricing methodology prescribed by its domestic law comprises the use of predetermined margins used in the context of the cost plus and resale price methods. Also, the comparable uncontrolled price method is accepted. These methods are applied differently in import and export operations.[67] Nonetheless, the use of transactional profit methods is denied.[68] Traditionally, the main downside of the Brazilian system lies in significant biases toward certain forms of investment and inbound economic activity, although amendments have taken place over time to refine the system.[69] Meanwhile, the last developments on the future of the Brazilian experience are not very promising. Specifically, in February 2018, the OECD agreed on a 15-month work program with Brazil to assess the potential for Brazil to move closer to the OECD's transfer pricing rules.[70] Meanwhile, in July 2019, a joint statement by the OECD and the Brazilian federal government points toward the abandonment of the said system in favor of the adoption of the OECD standard,[71] an outcome that has been criticized by Brazil's most prominent

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66. For a description, see U.N. 2017 PMTP, *supra* note 16, § D.1 ("Brazil Country Practices"). The amount of literature devoted to examining the Brazilian experience is overwhelming. A great reference work on the subject matter may be found in Ricardo André Galendi Júnior & Luís Eduardo Schoueri, *Brazil*, 102b Cahiers de Droit Fiscal Int'l 191 (2017).

67. *See* Picciotto, *supra* note 6, at 32.

68. These are the Transactional Net Margin Method prescribed in *TPG 2017*, *supra* note 16, ¶¶ 2.62–2.113 and the Profit Split Method, analyzed in *id.* ¶¶ 2.114–2.155; *see also* OECD, *Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10* (2018), http://www.oecd.org/tax/beps/revised-guidance-on-the-application-of-the-transactional-profit-split-method-beps-action-10.pdf.

69. *See* Turina, *supra* note 14, at 322; *see also* Picciotto, *supra* note 6, at 32.

70. *See OECD and Brazil Launch Project to Examine Differences in Cross-Board Tax Rules*, OECD (Feb. 28, 2018), https://www.oecd.org/tax/transfer-pricing/oecd-and-brazil-launch-project-to-examine-differences-in-cross-border-tax-rules.htm; *see also* Tatiana Falcão, *Is Brazil's Tax System Ready for OECD Accession?*, 89 Tax Notes Int'l 181 (Jan. 8, 2018).

71. *See Joint Statement on the OECD—Brazil Transfer Pricing Project*, OECD (July 11, 2019), https://www.oecd.org/tax/transfer-pricing/joint-statement-oecd-brazil-transfer-pricing-project-july-2019.pdf.

international tax scholars as a missed opportunity to explore the enhancement of the predetermined margins approach.[72]

The struggle of the OECD to maintain the arm's length standard as the only acceptable solution to profit allocation so far has been the remarkable consensus in its adoption worldwide.[73] The arm's length rationale is embedded in almost all double tax conventions in force, and legislation of a considerable number of jurisdictions follow OECD recommendations on the subject. At a more pragmatic level, the insistence on maintaining the arm's length principle in its purest form relies on the fact that the OECD is, by far, the most relevant institution when it comes to its interpretation and the drafting of recommendations aimed at an appropriate implementation. Hence, standardization is governed by the OECD and well capitalized by developed countries' MNEs, with enough resources to profit from complexity, as well as by a "large, economically wasteful industry which exists only to serve the need to supply these particular valuations."[74] The described scenario has not been contrasted so far by the transfer pricing guidance of the United Nations that, despite adopting a receptive approach to simplification,[75] does not display an effort to endorse it sufficiently in spite of its relevance for developing countries.

As opposed to the described state of art, it is the purpose of the author to eliminate prejudices that entrench transfer pricing rules based on the comparability analysis as the only possible solution to income allocation among related parties and to devote the next Parts to proposing arguments in favor of simplification through predetermined margins and methods as a means to mitigate unnecessary

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72. See the joint statement presented by Romero Tavares and Professors Sergio Rocha, Luís Schoueri, and Heleno Torres. *See* Luís Schoueri, *Brazilian TP: Missed Opportunities Ahead*, Kluwer Int'l Tax Blog (July 30, 2019), http://kluwertaxblog.com/2019/07/30/brazilian-tp-missed-opportunities-ahead/.

73. *See TPG 2017*, *supra* note 16, ¶ 1.1 (describing the arm's length principle as an international standard); *id.* ¶ 1.15 (stating: "A move away from the arm's length principle would abandon the sound theoretical basis . . . and threaten the international consensus."); *see also* Andrus, *Tax Avoidance and Transfer Pricing*, *supra* note 20, at 435; Andrus et al., *supra* note 38, at 495.

74. Brauner, *Formula Based Transfer Pricing*, *supra* note 36, at 627.

75. *See* U.N. 2017 PMTP, *supra* note 16, § B.3.4 (describing the sixth method); *id.* § B.8.8 (mimicking guidance under the OECD Transfer Pricing Guidelines).

complexity in transfer pricing. At a more specific level, these proposals aim to proportionate argumentation for the empowerment of developing countries to adopt such measures in accordance with their respective needs and interests.

III. Means to Implement Simplification in Transfer Pricing

Complexity is often necessary to achieve certain policy goals and, thus, sometimes is unavoidable. On the contrary, unnecessary complexity is what should be considered as inherently negative and, thus, corrected.[76] Following Johnson's view of complexity, transfer pricing rules entail three types of complexity:[77] (1) Detail complexity, which exists when one can reach the right result, can figure out the result the law requires, but there are so many rules to wade through that it is exhausting to reach that right result; (2) outcome complexity, when the law is not clear about the result it commands (i.e., when different people reading the rules can reach different conclusions); and (3) forms complexity, entailing just too much paper that taxpayers have to generate, file, and retain. All of them are caused by the fact that, to comply with transfer pricing rules following the arm's length standard, a thorough comparability analysis must be undertaken and documented accordingly.

Notwithstanding, as it will be shown, transfer pricing indeed entails expendable complexity that could be avoided without compromising its arm's length rationale. To that end, first of all certain measures aligned with the current *status quo*—meaning, transfer pricing rules based on the arm's length principle—will be discarded due to the fact that they do not entail simplification. Once confirmed that simplification can only be identified with measures dodging the necessity of the comparability analysis, then the predetermination of margins and methods is the only meaningful path to achieve a simpler, better administrable system, still based on the arm's length rationale, understood as comprising market outcomes. In that regard, a further differentiation will be needed to distinguish between rebuttable and irrebuttable presumptions of the compliance with transfer pricing rules.

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76. *See* Cooper, *Themes and Issues*, *supra* note 5, at 431.

77. *See* Johnson, *supra* note 30, at 582; *see also* Ellsworth C. Alvord, *Possibilities of Future Tax Law Simplification*, 6 Nat'l Income Tax Mag. 365 (1928).

A. Measures Facilitating the Application of Transfer Pricing Rules Do Not Necessarily Entail Simplification

The first group of measures to be mentioned do not entail simplification per se but rather means to facilitate the accomplishment of a sound comparability analysis. In this sense, these measures are suitable to help both taxpayers and tax administrations—especially those in developing countries—to comply with transfer pricing rules based in the arm's length principle, but they cannot be regarded as a means to achieve a simplified system.

Capacity building programs that contribute to enhance knowledge among tax officials are a valid illustration of the preceding. Not by any means it can be stated that capacity building implies the simplification of transfer pricing standards. Instead, it aims to overcome the knowledge gap existing in countries in which transfer pricing rules were adopted without a proper training on the side of the tax administration on how to adequately administer them. In addition, to implement these capacity building programs, no normative modifications are needed whatsoever, as it just entails the training of tax officials by transfer pricing experts. Some examples include funding by Luxembourg, Switzerland, and the United Kingdom that resulted in an increase in revenue derived from transfer pricing adjustments. For instance, in Colombia transfer pricing adjustments made as a result of audits of multinational enterprises increased revenues ten-fold from US $3.3 million in 2011 to over US $33 million in 2014.[78]

In accordance with the OECD, "capacity building is one of the biggest challenges faced by developing countries. The lack of effective legislation and gaps in capacity may leave the door open to simpler, but potentially more aggressive, tax avoidance than is typically encountered in developed economies."[79] Paradoxically, a report on transfer pricing

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78. *See* IMF et al., *Enhancing the Effectiveness of External Support in Building Tax Capacity in Developing Countries: Prepared for Submission to G20 Finance Ministers* 31 n.43 (2016), http://documents.worldbank.org/curated/en/337691503666961906/pdf/119100-WP-PUBLIC-World-Bank-Document.pdf.

79. OECD, *Two-Part Report to G20 Developing Working Group on the Impact of BEPS in Low Income Countries* 37 (2014), http://www.oecd.org/tax/tax-global/report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf (emphasis in original omitted).

and developing countries elaborated by PwC, commissioned by the European Commission, stresses that "overall, there is a need to create far-reaching TP legislation in developing countries in order to reduce economic and legal uncertainty and foster investment and growth"[80] and thus neglects the possibility that uncertainty is indeed generated by this set of rules. As stated, this rather paternalistic view of addressing the issue does not contribute to ease the completion of the comparability analysis itself, nor does it help the capacitation of modest taxpayers that fall under the scope of transfer pricing rules or the judiciary itself.

The creation of public databases is another example of the said category. The availability of reliable information on comparability data would be a significant achievement to support both taxpayers and tax administrations to adequately enforce the arm's length principle.[81] Nonetheless, despite being a positive action toward more transparency and the encouragement for more exhaustive transfer pricing analyses, comparability is still demanding a strongly fact-based examination that entails significant documentation requirements and, thus, does not contribute to mitigate the inherent complexity of transfer pricing rules.

Measures to better perform transfer pricing risk assessments fall also in this category. The aim is to provide tools for the tax authorities to better acknowledge which taxpayers perform high-risk transfer pricing planning in order to perform inspections. This allows for a more efficient allocation of the limited resources available for the public revenue to review the application of transfer pricing rules.[82] The assessment of both global tax risk and specific tax risk gives the tax authorities a strategic management tool that allows it to make a decision based on the specific characteristics of each taxpayer.[83] Yet these

80. PwC, Transfer Pricing and Developing Countries: Final Report 42 (June 2011), https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/transfer_pricing_dev_countries.pdf. No recommendations on the implementation of safe harbors are included whatsoever.

81. *Id.*

82. *See* Andrus, *Tax Avoidance and Transfer Pricing*, *supra* note 20, at 437.

83. *See, e.g.*, OECD, *BEPS Action 13: Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment* 20 (2017) (giving the example of Chile). Australia applies a risk-rating system in transfer pricing matters, consisting of a scoring system for evaluating the quality of a taxpayer's transfer pricing documentation undertaking the comparability analysis. *See* Michael Butler et al., *Australian Taxation Office's Transfer Pricing Risk-Rating System*,

measures do not contribute to facilitate the enforcement of transfer pricing rules, neither from the side of the taxpayer, nor from the revenue authority perspective.

Another measure that is usually mentioned in the context of the discussion of simplification measures in transfer pricing without really entailing simplification is the improvement of advance pricing agreement (APA) programs. An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g., method, comparables, and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations.[84] APAs certainly play a very important role in transfer pricing, referring to the reduction of uncertainty. The truth is that uncertainty is also one of the positive results of simplification, but both outcomes do not always come together. APAs illustrate this because their negotiation is based in the application of the comparability analysis and thus demands a case-based thorough examination to reach an appropriate arm's length result. The improvement derived from an APA refers to the fact that the tax administration(s) and the taxpayer agree on a common result, which usually implies the avoidance of litigation. Yet, the process cannot be labelled as a simplification of the rationale of transfer pricing rules.

Another option to facilitate the task of performing a comparability analysis is to ease the accuracy that the comparability analysis demands through accepting the use of imperfect comparables.[85] Usually, comparability adjustments permit the adaptation of a comparable, the elements of which are close to the controlled transaction under review but which has certain components that are not appropriately aligned and, thus, help to improve the resemblance of the comparable and the controlled transaction by taking into account the features of the latter.[86] Notwithstanding, this proposal would entail the use of references that, even after performing comparability adjustments, cannot be considered

22 Int'l Transfer Pricing J., no. 2, 2015, at 71, 73–74; *see also* Collier & Riedel, *supra* note 38, at 714.

84. *See TPG 2017*, *supra* note 16, ¶ 4.134.

85. *See* Hofmann & Riedel, *supra* note 19, at 320.

86. *See* Navarro, supra note 13, § 4.1.3.1.

as suitable references. The adoption of such an approach would be hard to formulate in specific regulations and must be regarded as undesirable, because it does not entail simplification and, in addition, implies an undermining of accuracy in the analysis in exchange for a meaningless relaxation on the performance of the comparability analysis.

B. Rebuttable Presumptions Based on Predetermined Margins and/or Methods. An Arm's Length Compliant Approach to Simplification in Transfer Pricing

The measures that will be commented on herein preserve the status quo of transfer pricing rules based on the arm's length principle while at the same time encompassing genuine simplification. The feature that best characterizes these measures lies in the fact that their only policy aim is to enhance the system by making it easier to administer (i.e., there are no goals beyond simplification). These measures would entail the predetermination of the arm's length outcome through pre-established margins and methods, while permitting at the same time, if the taxpayer proves that the result does not match the arm's length principle, the proposal of an outcome that fits within that standard. Through the adoption of predetermined margins, the intricacy of the comparability analysis, stringent documentation requirements, and burden of proof issues would be overcome.

A positive attribute derived from the enactment of these measures lies in the fact that the consensus reached on the arm's length principle, as built in the worldwide double tax convention treaty network through provisions akin to article 9 of the OECD model convention, remains intact. Moreover, the adoption of rebuttable margins at the end of the day entails no more than a reversal in the burden of the proof, a path that the OECD has already undertaken in the context of hard-to-value intangibles[87] and is exploring in the field of the valuation of financial transactions.[88] This means that the solution proposed fits within agreed standards without posing additional controversy.

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87. *See TPG 2017*, *supra* note 16, ¶ 6.192; *see also* OECD, *BEPS Action 8: Hard-To-Value Intangibles* ¶ 9 (2015), https://www.oecd.org/ctp/transfer-pricing/discussion-draft-beps-action-8-hard-to-value-intangibles.pdf; *2018 Action 8*, *supra* note 22, ¶ 2.

88. OECD, *Public Discussion Draft: BEPS Actions 8-10: Financial Transactions* 19 (2018).

Rebuttable margins and methods also are in line with the rationale of the framework defined around the establishment of agreed guidance to undertake the comparability analysis. At the end of the day, when a taxpayer or the tax administration follows the recommendations contained in the Transfer Pricing Guidelines on functional analysis, suitable methods, comparability adjustments, and other issues, and perform a proper inquiry to arrive at a reasonably accurate result, this entails a certain degree of predetermination in the fulfillment of the arm's length standard. To put it in other words, a certain predetermination is necessary due to the fact that transfer pricing rules encompass an open mandate—specifically, a market outcome that will necessarily depend on the facts of each case—that has to be concretized. In this sense, the outcome of transfer pricing rules is arriving at a reasonable result among different possibilities, hence the subjective component of transfer pricing rules. Usually, in the context of a discussion between a taxpayer and the tax authorities about the most appropriate arm's length outcome, the posture that will prevail is the one displaying an outcome that better complies with this standard. Rebuttable presumptions would render such a discussion not necessary through the establishment of a reasonable arm's length reference from which, if the taxpayer wants to deviate, the taxpayer will first have to prove that the predefined margin does not conform to the arm's length standard, and second, that its alternative proposal does comply. This double burden of the proof would be justified because, if the fixed margin can be regarded as entailing an arm's length result, the aim of the arm's length standard would have been fulfilled and, therefore, it would be insufficient for the taxpayer to demonstrate that its alternative proposal complies with the arm's length standard, or that the projected outcome entails a better accomplishment of it. This is a positive factor, as it would create an incentive to use predetermined margins or methods instead of conducting a traditional comparability analysis.

Apart from a significant abatement of complexity, predetermined references entail improvements in the following scenarios. First, when a taxpayer decides not to enforce transfer pricing rules, the tax administration would not be forced to conduct a comparability analysis to determine its taxable base. Instead, a straightforward application of the margins would be sufficient to assess potential adjustments on the taxable base of the taxpayer.

Second, fixed margins ban the adoption of inadequate references by the tax administration when determining the arm's length result derived from a controlled transaction, regardless of the cause,

including ignorance on how to endeavor a comparability analysis or straightforward corruption.[89] This is especially relevant in jurisdictions in which tax officials are not familiarized with the functioning of transfer pricing rules. Third, the adoption of fixed margins diminishes pressure from the side of courts when assessing a transfer pricing case, especially in those jurisdictions in which tax matters are reviewed by non-tax specialized bodies. Thus, in the context of litigation, instead of having to decide between the arm's length outcome proposed by the tax administration or that of the taxpayer, a court would just have to decide whether the taxpayer has demonstrated that the outcome derived from the fixed margin is not arm's length, while the administration's proposal is. Administrability issues are thus drastically diminished, making the option of the introduction of predetermined margins and methods more a necessity than an option, especially in developing countries.

Rebuttable presumption measures would diminish the need for tax inspections, as the number of taxpayers performing comparability analyses would be lower and, thus, resources could be allocated more efficiently. From the side of the taxpayer, complexity would be elective, albeit it is true that if a taxpayer chooses to prove that a fixed margin or a fixed method result is contrary to the arm's length standard and adopts a transfer pricing analysis, tax authorities would have to face the same complexity in the context of this specific case. Notwithstanding, the chances that tax administration would have to confront the position expressed by the taxpayer increase, as tax authorities could demonstrate that (1) contrary to the opinion of the taxpayer, the fixed margin or method leads to an arm's length result or (2) that the outcome proposed by the taxpayer derived from the comparability analysis undertaken is contrary to the arm's length principle. If the revenue authority succeeds in that regard, the fixed reference should prevail.

Moreover, on another level, simplification measures can be enacted with a specific policy in mind, while complying with the arm's length standard. This rationale could for instance be achieved by predetermining the application of a certain comparability method. Actually, the issue the BEPS project seems to struggle with the most is the use of one-sided methods instead of two-sided ones, especially the profit

89. Corruption is a common concern in certain jurisdictions, see Hofmann & Riedel, *supra* note 19, at 318; Benjamin A. Olken & Rohini Pande, *Corruption in Developing Countries*, 4 Ann. Rev. Econ. 479 (2012).

split method[90] in the context of the valuation and allocation of intangible related returns.

It seems that remuneration calculated in accordance with one-sided methods could be justified under a comparability analysis and therefore may be used. On the other hand, a distribution of the total profit according to functions performed could also be considered as adequate to remunerate each party. That is to say, the mandate the arm's length principle imposes could be achieved through both means, yet the results would drastically vary.

Again, a crucial aspect in this context refers to the distribution of the burden of proof when applying transfer pricing rules. If the taxpayer applies the comparability analysis in a manner that reflects what independent parties would have agreed with, the required "at arm's length" outcome will have been fulfilled. In such a context, the tax administration departs from a weakened position, as it would not only have to prove that the outcome it proposes complies with the arm's length standard, but also—first and foremost—that the one provided by the taxpayer in its tax return does not.

A suitable solution to such a scenario consists in the predetermination on the use of two-sided methods based on the contribution of each party to the transaction according to an agreed proxy in those situations in which the risk profit diversion is higher, while at the same time leaving the taxpayer the opportunity to present strong evidence of the fact that the result contradicts the arm's length principle, while the outcome it proposes is in accordance with it. Also, when drafting regulations in this respect, another nuance could be added, namely, that the alternative proposed by the taxpayer resembles as much as possible the outcome derived by the mentioned application of two-sided methods.

The implementation of such a measure would take place under the domestic law of those States that regard the proposed solution as sound. The outcome perfectly complies with the content of the arm's length principle, as this provision does not mention burden-of-proof standards and yet, the predetermination of the use of two-sided methods could still be reversed by the taxpayer, albeit a higher burden-of-proof should be met. The predetermination of two-sided methods would entail simplification, as the taxpayer can rely on the fact that, if it applies adequately the indicated methods, the tax administration should not

90. In the same vein, see Collier & Riedel, *supra* note 38, at 715; Vann, *supra* note 23, at 324.

re-assess the result. It may thus be regarded as a safe harbor, as it would be assumed that the arm's length principle is complied with through such presumption. Those taxpayers that have the resources to challenge the use of two-sided methods in favor of one-sided methods would find that the entry barriers are higher, and the risk of assessment also are increased. Thus, apart from simplification, it provides disincentives to the use of one-sided methods that may result in profit shifting.

Additionally, it has to be remarked that the proposed approach does not imply a presumption of the existence of abuse, as within the context of the arm's length principle, the existence of abuse is irrelevant to determine whether an adjustment should be performed. Not even tax savings are required for transfer pricing rules to be applied, although in certain jurisdictions, transfer pricing rules only apply in upward adjustments scenarios, but not when the adjustments imply the attribution of less profits to the tested party.[91] On the other hand, the arm's length principle also applies to rational transactions undertaken due to valid economic reasons other than tax savings. Adjustments on profits are conducted regardless of this factor.[92]

According to the OECD, the availability of safe harbors for a given category of taxpayers or transactions may have adverse consequences.[93] The first concern refers to the fact that the implementation of a safe harbor in a given country may lead to taxable income being reported that is not in accordance with the arm's length principle. Notwithstanding, this is a logical consequence of predetermination,

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91. *See Income Tax Assessment Act 1997* (Cth) ss 815–830(1) (Austl.); Gesetz über die Besteuerung bei Auslandsbeziehungen [AStG] [External Tax Relations Act], § 1, https://www.gesetze-im-internet.de/astg/AStG.pdf (Ger.) (adjustment of income); Income Tax Act, 1961–2019, § 92(3) (India); Memorandum from Office of Chief Counsel, IRS, to Supervisory Appeals Officer, Memorandum AM-2007-007 (Mar. 15, 2007) (U.S., within the framework of the commensurate with income standard).

92. See, in the same vein, Rectenwald, *supra* note 4, at 435. *See also* James R. Mogle, *Intercompany Transfer Pricing in the 1990's: Trading Old Lamps for New Ones?*, 69 TAXES 961, 964 (1991) (referring to U.S. regulations); John S. Nolan, *U.S. Final Transfer Pricing Regulations*, 50 U. MIAMI L. REV. 537, 543 (1996).

93. *TPG 2017*, *supra* note 16, ¶¶ 4.110–4.126; *TPG 1995*, *supra* note 49, ¶¶ 4.103–4.120; OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* ¶¶ 4.102–4.119 (2010), https://doi.org/10.1787/tpg-2010-en; Lewis, *supra* note 55, at 454.

namely, the outcome of safe harbors will differ at a certain degree with that of a thorough comparability analysis. Indeed, no one discusses the fact that there is a tradeoff consisting in fostering simplicity and certainty at the expense of accuracy. Therefore, such an outcome cannot be labelled as an issue, but as the necessary consequence to achieve the described aims.

Second, the OECD states that safe harbors may increase the risk of double taxation or double non-taxation when adopted unilaterally. The truth is that double taxation may arise, resulting from the possible denial of the adoption of a corresponding adjustment by the jurisdiction in which the counterparty—the related entity—resides, due to non-compliance with the arm's length standard.[94] But in the context of rebuttable safe harbors, this is an outcome that the taxpayer can choose to avoid by demonstrating that the outcome of the application of the specific predetermined margin or method is contrary to the arm's length mandate and at the same time by conducting a comparability analysis to pinpoint the adequate valuation of the controlled transaction. Therefore, double taxation can still be avoided by the taxpayer.

On the other hand, it is true that predetermined margins or methods may entail a potential loss of tax revenue resulting from under-taxation.[95] As stated by the OECD, if a unilateral safe harbor permits taxpayers to report income below arm's length levels in the country providing the safe harbor, taxpayers would have an incentive to elect application of the safe harbor,[96] but a couple of nuances should be considered. First, a comparison should be made between such a loss and the gain derived from simplification, both for the perspective of the tax authorities and the taxpayer. Second, a jurisdiction enacting safe harbors is already assuming the risk of a certain loss, but this risk may be compensated through a well drafted set of rules that help to overcome profit shifting. For instance, the commented measure on the adoption of an arm's length outcome as close as possible to the outcome derived from the use of a profit split mechanism could overcome significant profit shifting concerns, expressed by the OECD. As per any tax rule, an appropriate design can minimize risks and boost potential upside effects. Moreover, a reduced tax burden, combined with the increased certainty

94. Indeed, DTC measures to avoid economic double taxation.

95. *See TPG 2017*, *supra* note 16, ¶ 4.113.

96. *See id.* ¶ 4.118.

that simplification brings, could boost investment and thus be positive overall.[97]

Another concern expressed by the OECD regards the fact that safe harbors potentially open avenues for inappropriate tax planning, through profit shifting means. Notwithstanding, to regard profit shifting as an issue in the context of safe harbors is fairly dishonest, when compared to plain arm's length rules.[98] The shifting of taxable income will exist no matter what; the difference being that in the case of a jurisdiction that adopted safe harbors, an acceptable level of profit shifting is already disclosed, thus enhancing certainty.

The last concern pinpointed by the OECD regards issues of equity and uniformity. These challenges refer to the design and implementation of safe harbors. Usually, predetermined margins may be suitable for low value added or routine activities,[99] yet margins are not akin in every industry sector, not to mention complex transactions involving intangible assets or restructurings, just to mention two high risk areas. This is why the most relevant issue to be faced when designing safe harbors is to try to approximate their outcome to an arm's length equivalent as much as possible, by considering the specificities of industries and sectors, market circumstances, and transaction specificities as far as possible. Hence, the collection of information on similar uncontrolled references, the allowance for limited adjustments in line with the facts of the case, and the regular update of the adopted parameters are

97. Collier & Riedel, *supra* note 38, at 716:

> [T]he fundamental dilemma encountered by countries in the developing world, as well as, to a lesser extent, by developed economies, is to balance the countervailing objectives of, on the one hand, raising significant amounts of revenues from mobile and often highly tax-sensitive MNEs and, on the other, attracting mobile capital investment to the country.

98. *TPG 2017*, *supra* note 16, ¶ 4.122.

99. *See* OECD, *2014 BEPS Action 10*, *supra* note 59, ¶ 7.57 ("The mark-up selected by the taxpayer should be no less than 2% of the relevant cost and should be no greater than 5% of the relevant cost."); *see also* OECD, *Aligning Transfer Pricing Outcomes*, *supra* note 31, ¶ 7 61 (going even further stating that "the mark-up shall be equal to 5% of the relevant cost," thus establishing a single valid percentage instead of a range).

cardinal for the righteous functioning of these measures.[100] In this respect, the OECD claims that accurate safe harbor parameters could erode administrative simplicity, but this fact is very questionable because the determination of meticulous predetermined margins or methods will be always simpler and more preferable than a case-by-case examination of the compliance of a comparability analysis documented by the taxpayer.

C. Irrebuttable References Should Also Be Explored as a Policy Option, Especially in Strategical Sectors

If the purpose of the legislator of a given jurisdiction is to curtail profit shifting while fostering simplicity, even at the expense of failing to comply with the arm's length mandate, the irrebuttable predetermination of margins or methods remains a policy option that deserves to be explored. Through irrebuttable references, a higher grade of simplification is achieved. On the one hand, the taxpayer would be forced to accept simplicity through the application of predetermined margins or methods, instead of facing the dilemma that exists in a rebuttable predetermination system about the pros and cons of conducting a comparability analysis in order to deviate from existing rebuttable safe harbors. Notwithstanding, some advantages that are present in the "rebuttable predetermined margins and methods" option commented on above disappear in the context of irrebuttable safe harbors. The first and most evident one regards the abandonment of the consensus on the use of the arm's length standard based on the comparability analysis.

The second disadvantage refers to double taxation. As per rebuttable safe harbors, existing economic double taxation is assumed by the taxpayer as a downside effect preferable to the compliance with the draconian documentation requirements and inquiries that the comparability analysis imposes.[101] In the case of irrebuttable predetermined margins or methods, the risk of double taxation could not be avoided by the taxpayer itself, but through means of a bilateral advance pricing agreement,[102] or a mutual agreement procedure,[103] albeit one must take into

100. *TPG 2017*, *supra* note 16, ¶ 4.112.

101. *Cf. id.* ¶ 4.116.

102. *See id.* ¶ 4.173.

103. *See* OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017, art. 25 (2017), https://doi.org/10.1787/mtc_cond

account that corresponding adjustments usually are calculated by reference to the arm's length standard,[104] and thus, rules referred to corresponding adjustments are not directly enforceable in this context.[105] Also, this risk could be overcome by the adoption of bilateral or multilateral competent authority agreements.[106]

A third disadvantage would be that a badly designed system of predetermined margins or methods could have perverse effects on the pricing decisions of enterprises.[107] Such an outcome could also be predicated on rebuttable safe harbors, albeit in this case the consequences would be incremental, as no opt-out would exist for companies. Anyhow, one must not forget that the purpose of these rules refers to the calculation of the taxable base of related entities, and thus, transfer pricing management decisions referred to an efficient allocation of resources would not be so dramatically impacted.

The truth is that the ideal solution depends on several factors, such as the interest of the country to maintain the consensus over the application of transfer pricing rules exclusively based on the comparability analysis, the willingness to promote simplicity among taxpayers and tax administrations, the need to fight profit shifting, its bargaining power vis-à-vis other relevant jurisdictions and so on. As a result, all jurisdictions should be encouraged to address the issue and especially those with less available resources to manage such a complicated set of rules, while being aware at the same time that a balance between consensus and simplification is quite difficult to achieve. Probably in most of the cases, a sound solution would entail the adoption of a combination of measures. For instance, the adoption of a scorecard system to assess transfer pricing risk, combined with irrebuttable safe harbors for

-2017-en [hereinafter OECD MTC 2017]; OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, art. 16 (2016), https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf [hereinafter MLI] (opened for signature Dec. 31, 2016); *see also* OECD, *Commentaries on the Articles of the Model Tax Convention*, art. 25, ¶ 10 (2017), http://www.oecd.org/ctp/model-tax-convention-on-income-and-on-capital-full-version-9a5b369e-en.htm.

104. *See TPG 2017*, *supra* note 16, ¶ 4.

105. *See* OECD MTC 2017, *supra* note 103, art. 9.2; MLI, *supra* note 103, art. 17.

106. *TPG 2017*, *supra* note 16, ¶ 4.119.

107. *Id.* ¶ 4.128.

low-risk transactions would allow the tax administration of a given country to concentrate their review efforts in complex taxpayer transactions. On the other hand, the adoption of irrebuttable margins or methods in strategical sectors or industries with inelastic demand could make sense when concerns of the jurisdiction regarding profit shifting are significant, as shown in the example of the adoption of the sixth method by several Latin-American countries.

IV. Conclusion

It is the aim of this contribution to sustain that, despite the inherent complexity that the enforcement of the arm's length rationale entails, it is feasible—and desirable—to introduce simplification measures without abandoning this worldwide accepted standard, especially in the context of developing countries and despite reticence shown by international organizations such as the OECD. It has been shown that complexity in transfer pricing erodes fairness and equity and promotes profit shifting, which paradoxically constitutes the opposite outcome that this set of rules wants to achieve. This is the reason why it is urgent to propose and encourage the adoption of a means to neutralize unnecessary complexity in this field.

Specifically, rebuttable predetermined margins and/or methods are proposed in this contribution as the best solution in a context in which policymakers want to keep the arm's length rationale intact. Also, even despite its shortcomings, irrebuttable predetermined safe harbors should be considered potentially feasible and a valid policy option in strategical sectors with inelastic demand. At the end of the day, the adoption of specific measures depends on several factors, such as the interest of the country in maintaining the consensus over the application of transfer pricing rules exclusively based on the comparability analysis, the willingness to promote simplicity among taxpayers and tax administrations, the need to fight profit shifting, its bargaining power vis-à-vis other relevant jurisdictions, and so on.