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THE ARM'S LENGTH PRINCIPLE: A PANACEA OR PROBLEM TO REGULATING TRANSFER PRICING TRANSACTIONS BY MNEs IN DEVELOPING COUNTRIES

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Abstract

Transfer pricing manipulation by multinational enterprises is a big problem in developing countries, considering the increased levels of tax avoidance and evasion in these countries. The revenue lost through evasion and avoidance schemes as well as through aggressive tax planning robs developing countries of the much-needed domestic revenues to fund public expenditure. The repercussions of revenue inadequacies are evident in developing countries' governments to adequately invest in education, tax administration, health and security, infrastructural development, and economic development. Most developing countries having enacted transfer pricing regulation, with the arm's length principle are at the core of these regulations. This principle has been criticized in literature for its inefficiency and ineffectiveness in regulating transfer pricing in evolving economic times, while some researchers continue to maintain its relevance. In view of the conflicting views on the cogency of the arm's length principle in developing countries, this paper sought to unpack this debate through an evaluative review to show the areas of disagreement and agreement among scholars. The review was motivated by the continued concern and discussions of tax evasion and avoidance by multinational enterprises through aggressive transfer pricing in developing countries. Through a critical literature review, this article assesses the applicability and relevance of the principle in developing countries. Findings reveal controversies in the availability of comparable data, continued abuse of transfer pricing as well as the difficulty in applying the principle in digital transactions and intangibles.

Keywords: Arm's Length Principle, Transfer Pricing, MNEs, Legislation, Tax Avoidance, Taxation

1. Introduction

Transfer pricing (TP) as a tax avoidance tool has been a contentious subject for a long-time. Developing countries had been argued to suffer significant tax revenue losses due to TP abuse

by multinational enterprises (MNEs) (United Nations Conference on Trade and Development (UNCTAD), 2020; Kwaramba *et al.* 2016; Sebele-Mpofu *et al.* 2021b). The matter has been an issue of contemporary discussions on economic, political, and public arenas in general as well as tax administration platforms such as the African Tax Administration Forum. The scrutiny of MNEs' activities especially TP transactions and the heightened public and political interest on TP has changed TP from just being technical issue to fundamental matter. It has drawn the attention of tax authorities, civic organizations, governments, and international organizations such the Organisation of Economic Corporation and Development (OECD), the World Bank and International Monetary Fund (IMF). Developing countries such as Zimbabwe, Kenya, Tanzania, Zambia, and Mauritius among others have adopted the OECD TP guidelines and United Nations (UN) guidelines to regulate TP transactions (Beebeejaun, 2019; Kabala and Ndulo, 2018; Mashiri, 2018; Sebele-Mpofu *et al.* 2022). The objectives being to reduce Base Erosion and Profit Shifting (BEPS) by MNEs and to protect local industries from unfair competition from the MNEs by pricing intercompany transactions at arm's length. Strategies such as over/under-invoicing, debt shifting, management fees, tax haven transfers as well as the sale of intangibles and intellectual have been used to manipulate transfer prices between related companies to move incomes and minimize tax liability, thus maximizing group profits (Bhat, 2009; McNair *et al.* 2010; Sebele-Mpofu *et al.* 2021a).

The arm's length principle is the backbone of the OECD guidelines (Beebeejaun, 2018; Cooper *et al.* 2017; Oguttu, 2020), yet the adequacy and appropriateness of the TP pricing methods informing the application and enforcement of the principle have been contested among researchers (Davies *et al.* 2018; Eden, 2016). Scholars have questioned the relevance and applicability of the arm's length principle (ALP) in fairly and transparently pricing transactions and allocating taxing rights among different countries. The skepticism is even worse for developing country contexts where economic conditions differ from those developed countries and OECD countries. The ALP is applied to compute related party transactions so that they are priced just like transactions between unrelated or independent parties (Eden, 2019). The principle has also been a subject of criticism and debates concerning its applicability to developing countries' contexts where comparability data is not readily available (Cooper *et al.* 2017; Silberstein, 2009). Despite the adoption of the OECD guidelines that provide for the application of the ALP and the principle being the cornerstone of TP legislation, researchers have disagreed on key issues. These include the relevance and application of the principle in an evolving and dynamic business world (changing perspectives and changing times) (Rogers and Oats, 2021), the problems of applying comparability assessments (Oguttu, 2016, 2018, 2020; Taylor *et al.* 2015) and the lack of clarity in pricing transactions (Mashiri, 2018). Oguttu (2020) argues that the application of the ALP principle in developing countries (while pointing to African countries such as Zambia, Malawi, Angola, Kenya, Uganda, and Ghana among other) has significant conceptual and practical challenges. The re-characterization of transaction has difficulties both in theory and in practice. Other researchers allude to the increased TP disputes between taxpayers and tax authorities, the complicatedness of tax administration systems, increased documentation requirements and compliance burdens because of the insistence on applying the principle (Sebele-Mpofu *et al.* 2021a). In concurrence, Solilova (2018, p. 15) adduces that "the international tax rules, including the arm's length standard and tax systems seem to be inefficient and non-transparent and are not able to react to increasingly sophisticated tax planning structures". For some researchers, corruption, and the weak institutional environment in developing countries makes TP regulation more challenging and even tax administration in generally (Mashiri, 2018; Sebele-Mpofu, 2020a)

This study was motivated by the topical nature of TP regulation, the projected revenue losses in the African context and lack of consensus on the application of the arm's length principle in effectively regulating TP transactions and curbing tax avoidance by MNEs in developing countries. This study is a review of literature on the applicability of the arm's length principle, its criticism and possibilities for change or adaptability on the application of the principles. It contributes to theoretical literature and ongoing debate on whether the ALP provides a sufficient and reliable basis for determining the allocation of income between affiliated companies and in controlled cross-border trace activities. The paper also gives a brief insight into the possibility of the controversy on the applicability of the ALP during and post covid-19 pandemic, considering

the covid-19 pandemic driven economic responses, challenges and opportunities that varied with national and continental contexts. The paper also assesses the possible alternatives to the principle in legislating TP transactions. It evaluates whether the alternatives such as the unitary approach and formulary apportionment approach can be ideal replacements for arm's length principle or the arm's length principle could be amended to better achieve the objectives of reducing BEPS. The paper makes two important contributions. Firstly, being a review articles, it reviews previous studies and draws out the consistencies and inconsistencies from literature to show research gaps that can be pursued by future researchers. The strength of review articles is their ability to bring rich data from diverse studies under one study and this is crucial for new researchers in the subject area (Xiao and Watson, 2019). Secondly, by unpacking the pros and cons of transfer pricing, the article contributes to informing policy and practice. Revenue authorities and policy makers become aware of the possible challenges as well as strengths of the arm's length principle and therefore improve their TP regulation accordingly. Section 2 reviews the related literature to give a comprehensive analysis of the arm's length principle, accentuate the areas of controversies, agreements, and disagreements among researchers in relation to the principle. Possible research voids and implications are also discussed. Having given a brief literature review, the next section delves into the methodology adopted in conducting the review (Section 3). Section 4 gives a summary of the findings from the review. The penultimate section concludes the study and points out areas of further research and recommendations emanating from the study.

2. Literature review

2.1. Articulation of the arm's length principle in regulating TP activities of MNEs

TP is defined as the pricing of intra-group transactions or transactions between a parent company, its subsidiaries, or affiliates to allocate revenues and expenses accordingly in a manner that does not disadvantage certain tax jurisdictions (Bhat, 2009). However, because MNEs increasingly manipulate transfer prices from high to jurisdictions to low tax jurisdictions, the term has gained recognition as inextricably connected to tax avoidance (Arafat, 2021; Sebele-Mpofu *et al.* 2021a).

2.2. An overview of the arm's length pricing methods in TP regulation

The ALP is often described as elusive; hence, the unending contentions in the TP discourse. The OECD delineates five methods and successfully applying them can be arduous for both taxpayers and tax authorities because of capacity issues. However, their use has remained dominant despite the controversies. The methods are split into two categories namely, the traditional transaction methods category and the transactional profit methods. On one hand, traditional transaction methods measure terms and conditions of uncontrolled transactions and compares these with those between associated enterprises. The comparison is based on price and gross margins. On the other hand, the transactional profit methods are profit based, they measure the net operating profits realized from controlled transactions and compare them to the profit level realized by independent enterprises in a similar transaction.

The traditional transaction methods that rely on comparable data include the Comparable Uncontrolled Price (CUP), Resale Price Method (RPM), and the Cost-Plus Method (CPM). The transactional profit methods are Transactional Net Margin Method (TNMM) and the Transactional Profit Split Method (TPSM). All the methods are summarized in Table 1.

Table 1. ALP transfer pricing methods

Traditional transaction methods				
Details	Methodology	Where appropriate	Pros	Cons
CUP	Compares intragroup prices to transaction price between independent willing buyers and sellers	Suitable where comparable data exists	Direct and reliable	Will soon be inapplicable, because comparable transactions are rapidly ceasing to exist
RPM	Uses gross margin approach to compare intra-group gross margin to resale margin in the comparable uncontrolled business transactions- Top-down pricing approach	Most useful for distributors and resellers or manufacturing industry	Less demanding as fewer adjustments are required to account for product differences. This is because such differences are usually less material on profit margin than on price	Limited by its one-sided nature
CPM	Uses the gross profit margin approach- compares mark-up costs of controlled transactions against those of uncontrolled transactions – bottom-up pricing approach	Is most appropriate in the manufacturing and service industries	Simple and easy to apply. The information is often from internal sources and available	May discourage the manufacturer to control costs
TNNM	based on net profit indicators. It examines the net profit relative to an appropriate base (such as costs, sales and assets) that a taxpayer realizes from a controlled transaction	Commonly applied in transactions that involve provision of services between associated enterprises	Is trusted and used by both taxpayers and tax agents because finding comparable with this method is easier	Is a one-sided method and is less reliable than the first 3 methods because of its use of net margins which are sensitive to the cost structures of enterprises
TPSM	based on the information available on value added (contribution) of functions to complete the product/service rendered by each enterprise- Splits the profits between related enterprises to match arm's length price- joint product approach	More useful where the one-sided methods are inappropriate	Less risk of underestimation as TPSM is a two-sided method and is flexible	Maybe difficult to apply particularly because accessing foreign associates' data is a challenge

Source: OECD (2015)

2.3. Applicability of the arm's length principle in a developing country context

The relevance and applicability of the ALP principle has been a subject of controversial debate among researchers with others questioning the depth, breadth, and length of the principle in a modern, globalized, and digitalized world (Avi-Yonah and Pougá Tinhaga, 2017; Ballivet, 2021). Others insist that the principle remains relevant and applicable (Eden, 2019). Eden (2019) argues that the arguments that call for the abandoning of the ALP in relating TP in favor of other alternatives such a formulary apportionment are misguided and misconceived. The researcher suggests that the ALP is not the problem in developing countries, "but rather income tax design is the problem". The researcher further argues that developing countries offer tax incentives that are detrimental to revenue mobilization because these are often exploited by MNEs through

aggressive tax planning (tax avoidance) and evasion. Therefore, developing countries need to correct the legal loopholes exploited, close the complex gaps in tax systems and increase monitoring. Despite arguing that the ALP is responsible for the ineffectiveness of TP legislation, Eden (2019) acknowledges three important aspects in relation to TP. Firstly, that MNEs' manipulative behavior of TP transactions is done intentionally and in a planned manner which is also extensive. TP abuse continues to drain development from developing countries (high tax jurisdictions) to low tax jurisdictions. For example, from African countries to tax havens like Panama. Therefore, this points to misuse of the ALP by MNEs. Secondly, the difficulties in implementing the ALP due to the absence of comparables, especially intangibles. Thirdly, the fact that in wanting to treat transaction between related parties in a similarly manner, commercially and financially as those between independent parties ignore the synergies and economies of scale enjoyed by MNEs and their affiliates.

Disputes between taxpayers and revenue authorities also arise due to the ambiguity of the ALP and the methods used in its computation and these at times end up spilling into the courts. This is due to the failure by the revenue authorities and taxpayers to come to a consensus on the appropriate transfer price. The complexity of MNEs' structures, integration and digitalization of some operations complicate the application of the arm's length principle. Wier (2020) and Sebele-Mpofu *et al.* (2021a) attribute the ineffectiveness of TP audits to the uncertainty surrounding TP rules and methods of establishing arm's length prices. The researchers adduce that subjectivity associated with the methods of establishing the prices are subjectivity and the subjectivity weakness open room for TP manipulation and tax revenue leakages. MNEs compute arm's length benchmarks that are advantageous to them and with the help of tax consultants convincingly document and justify them.

It is acknowledged that the ALP might have been relevant, applicable, and acceptable under socio-economic conditions that prevailed at the time when the principle came into existence. Notwithstanding, this observation, changing socio-economic settings such as the advent of new technologies, globalization, digitalization of transactions as well as increase in the integrated, opaque, and idiosyncratic operations and structures of MNEs, have resulted in the application of ALP being challenging in some circumstances (Andrus and Collier, 2017; Pichhadze, 2020). This has resulted in the principle's adequacy and relevance being a subject of disputation. The question of adequacy, applicability and relevance is even more pressing in view of the Covid-19 induced economic recessions and responses that had an influence in business operations and pricing decisions.

The criticism of the ALP principle stems from several issues. These include challenges in relation to comparability analysis, the subjectivity of the ALP especially in the methods for calculating arm's length prices, the overlooking of synergies, the differences in developing and developed country conditions, the excessive documentation requirements, and complexities in the computation of the arm's length prices where comparable transactions are not in existence. Fleming *et al.* (2020) argue that though the ALP is a workable approach with international consensus, it has several major sticking points especially in relation to developing countries. Firstly, lack of ease of administration. The application of ALP introduces complexity in tax administration and compliance. Its application is often difficult to comprehend if not economically efficient. Secondly, the principle's inability to minimize TP manipulation by MNEs. The researchers acknowledge the inroads made towards the minimization of BEPS in developing countries through the enactment of TP legislation and adoption of OECD TP guidelines, but they are quick to point out that the ALP is not and will not be fully successful in curbing TP abuse. Thirdly, the ALP compromises the fairness and equity principles as it continues to allow distortion of taxing rights by moving incomes from high tax jurisdictions to low tax ones. Rogers and Oats (2021) and Oats and Rogers (2019) affirm the criticism of the ALP and attribute it to reasons that include its high dependence on comparables, excessive documentation requirements, intricacies and imprecision that perpetuates tax disputes and lastly the fact that it overlooks the fact that internal efficiencies existing in MNEs cannot be replicate with unrelated parties.

Despite the criticism, Titus (2021) argues that the ALP has three advantages, and these are the international acceptance, bringing equity in how related and unrelated companies are treated for tax purposes and the fact that it determines the true source of income in an accurate

manner. The veracity of these submissions has been questioned by researchers such as De Graaf and Visser (2018) on the basis overlooking internalization and synergies, failing to account for the economic realities of transactions and the lack of equitable distribution of income. The debates surrounding these issues are reviewed individually in the findings in Section 4.

3. Methodology

The study is qualitative in nature. The researchers conducted a comprehensive literature review on the controversies surrounding the application of ALP as a tool to regulate TP. The ALP is the heart of TP legislation in the OECD and in most African countries. The review focused on current papers on the ALP and TP debate especially in relation to the effectiveness of the former in reducing tax avoidance and evasion by MNEs. The objective was to assess the applicability and relevance the ALP in the ever-evolving business environment and in the face of the rapidly expanding digital economy. The researchers adopted a critical review approach. As posited by Snyder (2019) and Mpofu (2021), a critical review allows researchers gather relevant literature on the subject, critically review this literature to pinpoint the areas of agreements and diverging views in literature and to identify the strengths and weaknesses of theories in the area. The review would allow the researchers to spotlight research gaps and, in some cases, build or further enhance theories in the subject area or even build a conceptual framework. This article review literature from the Google scholar database, policy briefs, the EBSCO database and Scopus indexed papers where possible. The Google Scholar database which was the main database was chosen based on its comprehensiveness and its ability to offer diverse studies on the subject area. The database is described as comprehensive, extensive and easily accessible (Bandara *et al.* 2011; Cronin and Coughlan, 2016). Xiao and Watson (2019) assert that it a powerful open access database that offers journals, conference proceedings, theses and reports, thus it is “sufficiently robust” (Bandara *et al.* 2011). The search terms used were “arm’s length principle and transfer pricing in developing countries”, “the arm’s length principles and its relevance in regulating transfer pricing in changing times”, the controversy surrounding the applicability of the arm’s length principle in developing countries”, “challenges affecting the applicability of the arm’s length principle in developing”, “the applicability of the arm’s length principle in the covid-19 pandemic” and “options or alternatives to the arm’s length principle in ensuring fair taxation of MNEs in developing countries. The papers were then excluded and included based on the assessment of the abstract and introduction on whether they addressed the weaknesses and strength of the ALP as a TP regulating mechanisms as well as whether the papers were appropriate in discussing the applicability of the ALP, the controversies, contradictions and convergencies surrounding the principle as a legislative tool to ensure fair taxation of MNEs’ profits, to minimize tax avoidance and evasion as well as aggressive tax planning by these MNEs. Literature was reviewed until researchers found similar information to the one already reviewed in the previous papers and in this case, the researchers felt that saturation point was reached. This point being described as that point where further reviewing was not yielding any new information (Sebele-Mpofu, 2020b). All in all, papers were reviewed. The literature review findings were presented and discussed thematically, building on the themes that emerged from the reviews as well the subthemes.

4. Review results

This section discusses the review findings to show the controversy that surrounds the ALP and the possible suggestions on the methods that can be employed to ensure taxation of MNE profits in a fair manner.

4.1. Controversies surrounding the applicability of the ALP

This section discusses the review findings in relation to the relevance and applicability of ALP in developing country contexts.

4.1.1. Challenges relating to comparability analysis

The anchoring foundation of the ALP is the ability to make comparisons of “conditions of controlled transactions with those of uncontrolled transactions” (Solilova, 2018, p. 16). Comparability analysis is therefore central to the determination of AL prices and the selection of the appropriate TP. Suitability of the choice of method is linked to the nature of the controlled transaction and on functional analysis. Five comparability factors are considered. These are the features of the assets, goods or services being transferred, contractual agreements, economic settings of the contracting parties, business strategies employed the parties, and lastly the assets employed and risk assessments (Oguttu, 2020). Consideration is therefore, given to aspects such capabilities, assets logistics, wholesaling, distribution, research, and development as well as sales and marketing among others. Risks assessed include those such operational risks, strategic risks, business risks, transactional risks, financial risks, and other risks such as intellectual capital risks. Therefore, for comparability analysis to produce AL prices, it must be sufficiently thorough and detailed, taking into consideration both the qualitative and quantitative matters that a critical to the comparison. According to Solilova (2018, p. 19), a detailed comparability analysis must be “consistent, transparent, systematic and verifiable from the initial stages to the final stages of arriving at the comparable price”. Therefore, the dependence on the core premise of comparability analysis means that the principle is overly dependent on certain facts and conditions, thus making administration and compliance difficult for tax administrators and taxpayers respectively. In developing countries, comparables are unavailable due to limited companies in some sectors and industries. Developing countries’ markets are thin and comparable data scarce. Revenue authorities end up relying on foreign databases such as Compustat, and Orbis among others. These databases are expensive to access, and their data is often not applicable to developing country contexts. Oguttu (2020, p. 79) states that “critics of the comparability analysis equate finding a satisfactory comparable to ‘finding a needle in haystack’”. This situation gives too much room for discretion, open crevices for conflict and uncertainty. The lack of consistency in the application of the ALP especially its reliance on the assessment of the functions performed, assets employed, and risks faced or assumed points to a context dependence kind of pricing, signaling subjectivity.

4.1.2. Synergies and economies of scale ignored

Internal efficiencies, synergies, economies of scale and other advantages enjoy by MNEs and influencing their pricing decisions are ignored, only the tax avoidance motive is considered key, yet TP is not only tax motivated (Eden, 2016). There are other non-tax avoidance or evasion related motives such as efficiency, goal congruence and managerial motives (Bhat, 2009; Sebele-Mpofu *et al.* 2021b). These advantages cannot be reproduced for independent parties; hence comparing the controlled and uncontrolled transaction is considered fundamental flawed and counterfactual. Adjustments must be done that bring subjectivity, especially where comparable transactions do not exist. Oguttu (2020) submits that the ALP ignores other considerations besides tax that can have a distortion impact on the commercial and financial relationship between companies in a group. The researcher further points out that some differences between the prices of controlled and uncontrolled transactions could be due to the quantities purchased or supplied, insurance and risk provisions. For example, exchange rates risks and shipping costs. Such considerations include special contracts and the need to boost start-up affiliates. This is more prone to the areas of intangibles which are often difficult to value or a unique to companies.

4.1.3. Subjectivity of the ALP and continued manipulation by MNEs

Researchers such as Rogers and Oats (2021) and Kabala and Ndulo (2018) point to the subjectivity of the ALP. The researchers argue that AL pricing methods bring flexibility in pricing but at the same time increase ambiguity and lack of certainty in the acceptance of the chosen TP price by revenue authorities. Oguttu (2020, p. 78) contends, “the arm’s length principle becomes a matter of negotiation between tax authorities and multinational companies, with no clear criteria

for application". This is worsened by the complex and greatly integrated structure of MNEs with interdependencies, activities and transactions that are opaque and not available to independent parties. The subjectivity of the ALP and the discretionary powers given to tax authorities in its computation allows revenue authorities to maximize revenue mobilization by taking advantage of the uncertainty and on the other hand, MNEs exploit the uncertainty to abuse TP to avoid tax (Avi-Yonah and Musselli, 2019). The subjectivity of the ALP creates room for contradictions and contentions between taxpayers and revenue authorities, between tax authorities or tax officers in the same tax authority or tax authorities and those in tax advisory functions of MNEs such as tax experts and consultants. These differences in opinions ultimately lead to the possibility of tax disputes, amended assessments, tax penalties and unfavorable publicity for tax authorities. Researchers argue that potential TP disputes could be minimized using Mutual Agreement Procedures (MAPs) and Advance Pricing Agreements, though they point out that these are costly and not in existence for some developing countries (Mashiri, 2018; Sebele-Mpofu *et al.* 2021a). In cases where they are in existence, they are disadvantageous to developing countries who negotiate from a weak angle in terms of political power and negotiation expertise (Readhead, 2017; 2018).

4.1.4. Excessive documentation requirements and complexity of the tax system

The ALP brings excessive documentation requirements, greater information needs, and professional resource requirements (TP skills, technical expertise, and experience) (Davies *et al.*, 2018; Mashiri, 2018; Rogers and Oats, 2021). In affirmation, Oguttu (2020) portends that the need for diverse documentation on the contracts, assets employed, and risk assumed makes the application of ALP expensive and time consuming. Information asymmetry and lack of financial resources as well as inadequate skills and competencies often tilt the scales to the advantage of MNEs that have abundant resources and can afford the services of tax professionals (Sebele-Mpofu *et al.* 2021a). Therefore, they overwhelm tax authorities during audits, dispute resolutions and even in a court of law. The ALP requirements are argued to further complicate developing countries' tax systems. The intricacies surrounding the computation of the recommended TP methods has "proved to be an expensive and lucrative exercise" for tax papers and tax consultants respectively (Biondi, 2017). Avi-Yonah and Benshalom (2010, p. 8) in affirmation allude to the fact that the application and enforcement of TP legislation has "spawned a huge industry of lawyers, accountants and economists whose professional role is to assist multinational companies" in planning their TP activities and transactions to either avoid tax or ensure compliance with legislation. A view shared by Picciotto (2012) who adduces that the ALP in tax legislation has drawn revenue authorities and professional tax advisors in a complicated web with the former trying to enforce compliance and the latter deriving huge fees from assisting MNEs in tax planning in relation to TP regulation requirements. Biondi (2017, p. 3) states that "quite a consensus has progressively emerged that the working international tax regulation has generated overwhelming complex tax system that is ineffective in performing fair taxation. As a matter of fact, the application of the letter of the arm's length approach has enabled structuring opportunities by sophisticated parties, leading to actual tax payment reduction and even double non-taxation for involved jurisdictions". The situation is more difficult for developing countries with fragile tax administration systems (Kabala and Ndulo, 2018), yet ALP requires significant technical judgement and skill that is often lacking in developing countries. Considering the arguments by different researchers, the ALP increases both the administrative and compliance burdens for revenue authorities and MNEs respectively. Tax consultants benefit from this complexity (Mashiri, *et al.* 2021). The ALP therefore opens crevices for tax planning opportunities, tax avoidance and big business for tax consultants.

4.1.5. Increased abuse of TP despite the ALP requirement

Continued evidence of taxing rights distortions and income shifting under ALP. There is still increased inequity in revenue mobilization with developing countries on the losing side. The ability of ALP to reduce BEPS is still contested as evidence of revenue losses due to TP manipulation

under the ALP regulation is still mounting. Manipulation is still rampant in the extractive sector of African countries and the scope for revenue mobilization is limited despite the ALP enforcing TP regulations. This is not to say all the revenue losses are attributed to TP manipulation as there are other factors like corruption, abuse of and overgenerous tax incentives awarded by African countries (Oguttu, 2018) as well as weak legal and institutional systems (Sebele-Mpofu, 2020a) and reduced tax morale (Sebele-Mpofu, 2021). To sum it up, Rogers and Oats (2021, p. 94) state “Furthermore, the application of ALP in fact intensive situations to determine appropriate transfer pricing means each particular case will be slightly different and so cannot be compare, a key weapon of professional force”. The researchers portend that developing countries are disadvantaged because of lack of public data on comparable enterprises and their domestic tax administrative control and mechanisms maybe under-resourced or face aggressive transfer pricing challenges. This makes TP open to exploitative and manipulative behaviors of MNEs and their tax consultants.

4.1.6. Catering for intangibles

Transactions involving intangible assets have been found to be major channels of income shifting (Elemes *et al.* 2021). Intangible assets are complicated by their unconventional nature that makes it difficult for them to be accounted for and audited. This is often compounded by the lack of comparable transactions for intangible assets (Choi *et al.* 2021). The application of the ALP is weakened by its lack of specific and sufficient guidance for the treatment of this special class of transactions. Greil *et al.* (2018a) argue that ALP poses difficulties in administration, does not have a solid theoretical foundation, and gives room for tax avoidance. It also against this background that researchers such as Devereux and Vella (2017) question whether the current taxation systems allocate taxation rights in a fair and equitable manner particularly considering the challenges imposed by digital transformation. Digital goods and services can be traded online without the identity of the source or physical location. Researchers point to a mismatch between where profits are taxed and where value is or was created for some digital transactions (Greil *et al.* 2018a, b). The weaknesses of the ALP in dealing with intangibles is a big challenge especially in the digital economy where intangible assets are increasingly dominating the business landscape.

4.2. The Arm’s Length Principle and the Covid-19 pandemic: Implications and possible exacerbation of TP disputes

The Covid-19 pandemic has had significant impact on the economy, the supply chain, consumer demands and business decisions (Gould and Arnold, 2020). Responses to alleviate the impact of the pandemic resulted in governments resorting to lockdown measures and other protective measures. These measures have had significant impact on business decision, pricing decisions as well as on the survival and sustainability of operations for corporations. Transfer pricing decisions have also not been spared by the effects of the pandemic. The impact of the Covid-19 pandemic has substantial effect on pricing decisions, possibly compromising the reliability of third-party prices for comparability purposes to uphold the arm’s principle in TP. Waclawik (2021) revealed that Covid-19 had a significant impact on the financial data reported in the financial statements. Intercompany commercial agreements and normal pricing arrangements could have been affected by Covid-19 lockdowns. Possible disagreements between taxpayers and tax authorities may emanate this situation. The pandemic disturbed supply chains, economic demand patterns and heightened unemployment and reduction in operations as well as company closures (Dordevic and Dukic, 2021). Survival techniques could have led to non-arm’s transactions and variations from initial laid down commercial and intra-firm arrangements. This could also have resulted in increases in TP transactions including intercompany transfers such as lending and borrowing, interest free loans or those way below the market rates, discounted prices, and extended credit periods. Increased volatility, significant losses, as well as alterations to company structures could have been unexpectedly triggered by the covid-19 pandemic. This would complicate the already complex structures of MNEs and their transactions further compromising

the possibility of trading at arm's length. Even in cases where transactions are at arm's length and driving by the prevailing market conditions it would be difficult to justify comparability since the impact of the pandemic varied from one country to the other or one company to the other. Justification for pricing decisions would be inevitably necessary and difficult. Finding comparable third part transactions will be challenging for corporations because the covid-19 pandemic impacted differently on companies and was responded to differently. The general unavailability of comparable information in developing countries especially in the African continent will be compounded by company closures and the impact of the pandemic. The need for thorough, clear, and adequate documentation cannot be overemphasized. This on its own places significant burden on the taxpayer in the form of compliance costs, TP documentation requirements and the burden of proof. This raises questions on the applicability of the arm's length principle in unusual circumstances such as a pandemic, economic downturn, or other economic disasters. What happens if comparable information is unavailable? Audits and dispute resolution processes are affected.

4.3. Suggested alternatives to Arm's Length Principles and implications

The lack of clarity on the arm's length principle in pricing related party transactions has led to questions regarding its robustness and applicability in developing country contexts and even its relevance and appropriateness in the ever-evolving business world as well as globalized economy. In view of the dynamic business world where business structures and practices continuously change and the criticisms lodged against the ALP, researchers have highlighted the urgent need to consider alternatives (Avi-Yonah and Pougá Tinhaga, 2017; Eden, 2019). Other scholars have suggested adopting the formulary apportionment approach in allocating MNEs group profits to relevant tax jurisdictions in which the MNE operates (Fleming *et al.* 2020; Raymond, 2019; Rus, 2016; Sadiq, 2015). Others in support of continuance with the ALP suggest the need to improve ALP and correct the weaknesses surrounding the principle as the problem is centered on others factors not the ALP itself (Eden, 2019). Improving ALP is argued to be less recommended as it can be challenging, heightening the already complex requirements as well as the need for detailed supporting evidence to rationalize the use of a particular TP pricing method. This entails using a fixed formula for apportioning the profits (Oats and Rogers, 2019; Rogers and Oats, 2021). Brazil's fixed method and Argentina's sixth method were also discussed as some of the seemingly simplified methods of regulating TP in developing countries that emerged during the literature review.

4.3.1. Amending the ALP requirements

Eden (2019) argues in favor of amending the ALP and continuing to use in view of its flexibility, popularity, and acceptance. The researcher emphasizes that developing countries should continue strengthening anti-avoidance measures such as the levying of withholding taxes, thin capitalization rules and doing away with perverse tax incentives, deductions, and tax holidays. Rogers and Oats (2021) table that the ALP principle brings flexibility accompanied by uncertainty and complexity. Avi-Yonah *et al.* (2008) argue that even after amendment the ALP, there is still no guarantee of its acceptability to different tax jurisdictions' revenue authorities and the taxpayers themselves. Mazur (2016) adduces that the heightened globalization and digitalization of the business world provides an eminent need to consider moving from the ALP to the formulary approach. Picciotto (2018) affirms the need to consider formulary approach suggesting that the ALP price computation can be complicated, yet countries require simplified and easy to administer tax rules.

4.3.2. Formulary apportionment approach

The formulary approach advocates for profits of MNEs to be distributed across the countries in which the group and its affiliates operate based on a formula that considers income-generating activities. The key factors to base the formulae on could include labor, capital, and asset. The

approach is argued to have several advantages that include simplicity in administration, the fact that it leads to a reduction in tax evasion and avoidance, allows room for tax planning and reduces subjectivity (Raymond, 2019). Despite calls for the formulary apportionment approach, there are still questions though on its acceptability and administrability. Researchers point out that it is not easy to administer and requires gaining political cooperation if it is to be accepted internationally like the ALP yet getting support and international consensus is difficult. All countries must agree on a predetermined formula and getting the countries to agree is challenging and has political implications. Gaining political and international acceptance requires time and effort. There are also other risks associated with the approach. Raymond (2019) adduces that the formulary apportionment approach disregards individual facts and circumstances surrounding transactions, hence it is considered arbitrary. The approach does not consider the challenging issue of intangibles, differences in accounting and tax rules for different countries and the fact that the differences in rules and accounting reflect the economic, social political environment of these countries. Therefore, the political acceptability of an approach that calls for the standardization of the tax base as a foundation of the apportionment of taxes is doubtful (Gharky, 2012). Raymond (2019) tables other disadvantages such as the possibility of double taxation or non-taxation of some transactions as well the fact that some elements of the formula might still be manipulated by MNEs, thus distorting the real economic activity. The contenders of ALP believe that the move to formulary is inevitable. Rogers and Oats (2021) assert it would be better to grapple with the formulary approach than to continue struggling with the difficulties of the ALP. The researchers submit that it is better to do away with applying the imprecise ALP in the context of inconsistent national approaches. Biondi (2017) avows that a market-focused contractual viewpoint might view the formulary apportionment as rather arbitrary as it does not consider the actual or imaginary market prices, but an accounting-based dimension may have greater acceptance for the approach as on that brings simplicity in splitting taxable income across different tax jurisdictions.

4.3.3. Hybrid method

Other scholars advocate for a hybrid approach of combining both the ALP and the formulary apportionment referred to as the residual profit split method. Musselman (2020) believe this hybrid approach counteracts the current flaws in the ALP and maximizes on the strengths of both approaches.

The unitary approach advocates for one consolidated profit for the entire group. Proponents of the approach argue that it brings greater efficiency and fairness, considers economic reality of transactions, hence bringing greater certainty and minimizes TP abuse by MNEs as compared to ALP (Mills, 2019).

4.3.4. Brazil's fixed margin

Brazil legislatively applies margins on gross profit and mark ups. This brings administrative simplicity and does not demand for comprehensive functional analysis and the use of specific comparables. It is easier when it comes to regulating, administration and monitoring as compared to the ALP (Brockmeyer *et al.* 2017).

4.3.5. Argentina's sixth method

This is another simplified method, which seeks to modify the existing CUP method. The Argentinian 'sixth method' is a simplified version of the CUP method designed specifically for commodity transactions (Readhead, 2017). Although variations of the 'sixth method' exist, generally they rely on publicly quoted prices to assess arm's length prices in related-party transactions, for example from commodity exchanges (Musselli, 2019; Readhead, 2018). While globally several countries apply some version of the 6th method, in Africa, Zambia is the only country to implement it (Brugger and Engebretsen, 2022).

4.3.6. Digital service taxes

With the expansion of the digital economy and the transition of the economy from brick-and-mortar activities to digital activities, revenue authorities, governments, and development bodies such as the OECD and ATAF have been intensely considering ways to tap tax revenue from this technological and e-commercialization oriented sector (Megersa, 2020; Munoz *et al.* 2022; Olbert and Spengel, 2019). The digital economy has grown greatly due to the Covid-19 pandemic. The invisible nature of digital activities makes it difficult to tax them or even to allocate profits. While the foundation of the conventional international tax rules lies in the identification of the physical permanent establishment, the expansion of the digital economy calls for a rethink of these rules and the recognition of virtual establishments or significant market presence. While the OECD proposals and guidelines on DSTs are under way several countries both developed (Italy, Spain, and Britain) and developing (Zimbabwe, Tunisia, Nigeria, and Kenya) as some of the examples have introduced DSTs both direct and indirect taxes to collect taxes from the digital economy (OECD, 2015; Bunn *et al.*, 2020). Even though these are promising way to collect taxes in market jurisdiction without reference to physical presence, they characterized by controversies too and are currently a matter of debate among countries, civic organizations, revenue authorities and tax bodies as well as development bodies.

5. Conclusions, recommendations, and areas of further research

The study sought to evaluate the suitability of the arm's length principle in transfer pricing analysis. Its continued use and emergence of competing methods spurred the study. The results of the study may be valuable in resolving current debates, inform policy and contribute to the global tax reset. Results have shown that the importance of ALP cannot be overlooked. Though infested with several flaws, it is the dominantly used model globally. The ALP contains five optional methods, which are mainly affected by comparability issues and its susceptibility to abuse. The weaknesses of ALP have resulted in limited use of alternatives also referred to as the 6th method such as the unitary method, formulary apportionment, hybrid approach and fixed margin approach as well as digital services taxes (DSTs). There is still lack of consensus as to whether these alternatives adequately address the flaws in the ALP model to an extent that they can be fully depended on. Thus, modifying the ALP and considering the hybrid approach could be ideal position to take. Transfer pricing is not an exact science, and as such, stakeholders should always consider the appropriate model based on their existing circumstances and conditions. Plugging the legislative loopholes exploited by MNEs would be the first step towards minimizing revenue losses through transfer pricing. Further research should conduct an in-depth evaluation of each of the alternative methods, as well as seek means to comprehensively modify the existing ALP model. The limitation of the study is that being a literature review it is based on previous studies and could suffer from the biases linked to these studies. The study does not conduct any primary data collection or empirical research, which is another limitation. Future research could explore the possibilities and feasibility of applying the suggested methods and evaluate the success of these methods in countries that have implemented them.

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