

# **Reprinted from British Tax Review**

## **Issue 5, 2013**

*Sweet & Maxwell*  
**100 Avenue Road**  
**Swiss Cottage**  
**London**  
**NW3 3PF**  
*(Law Publishers)*

**SWEET & MAXWELL**

# The BEPS Action Plan and Transfer Pricing: The Arm's Length Standard Under Pressure?

Georg Kofler\*

## Abstract

*The OECD Action Plan on Base Erosion and Profit Shifting puts strong emphasis on substantive transfer pricing issues, devoting 3 of its 15 Actions to them. Aiming at assuring that transfer pricing outcomes are in line with value creation, the main concerns raised in the Action Plan relate to income shifting and the creation of “stateless income” through transfers of intangibles, the allocation of risks and capital, and transactions which would not, or would only very rarely, occur between third parties. This contribution will present the Actions identified in the Action Plan, put them into context, and identify potential routes for change.*

## Introduction

Entities of multinational enterprises (MNEs) are generally taxed separately in each country.<sup>1</sup> Hence, the allocation of taxing rights with respect to the separate entities of MNEs can have a major impact on the tax revenue of individual states, as a large portion of world business is between associated enterprises.<sup>2</sup> It is, therefore, generally recognised in international tax law that affiliated companies conducting cross-border business must do so on market principles, that is, they must act as if such business was being conducted between independent parties.<sup>3</sup> The price charged for goods and services—the transfer price—must be in accordance with the “arm's length principle”, which requires taxpayers to put a constructed or fictional market price on their non-market transactions to measure the profits to be allocated to each entity of the MNE.<sup>4</sup> The arm's length principle, though heavily criticised and perhaps a mere by-product of history,<sup>5</sup> is a globally-accepted standard in the area of international taxation. It is not only enshrined in Article 9 of the OECD Model Convention with Respect to Taxes on Income and on Capital (OECD MC) and maintained and developed in the *OECD Transfer Pricing Guidelines* (OECD TPG),<sup>6</sup> but is also employed in Article 9 of the United Nations' “Model Double Taxation Convention

\* Univ. Prof. DDr. Johannes Kepler University Linz.

<sup>1</sup> *OECD Transfer Pricing Guidelines* (OECD TPG), Preface, para.5.

<sup>2</sup> See, e.g. OECD TPG, above fn.1, para.1.3.

<sup>3</sup> H. Hamaekers, “The Arm's Length Principle and the Role of Comparables” (1992) 46 BIFD 602, 603.

<sup>4</sup> Y. Brauner, “Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes” (2008) 28 Va. Tax Rev. 79, 97; see, however, also J.S. Wilkie, “Reflecting on the ‘Arm's Length Principle’: What is the ‘Principle’? Where Next?” in W. Schön, and K.A. Konrad (eds), *Fundamentals of International Transfer Pricing in Law and Economics* (2012), 137, 144 and following and 152 and following, for a discussion of the difference between the concepts of profits and prices in light of OECD Model Convention with Respect to Taxes on Income and on Capital (OECD MC) Art.9, available at: <http://www.oecd.org/tax/treaties/1914467.pdf> [Accessed November 6, 2013].

<sup>5</sup> See S.I. Langbein, “The Unitary Method and the Myth of Arm's Length” (1986) 30(7) *Tax Notes* 625.

<sup>6</sup> OECD TPG, above fn.1, para.1.6, noting that “the authoritative statement of the arm's length principle is found in paragraph 1 of Art. 9 of the OECD Model Tax Convention.”

between Developed and Developing Countries" (UN MC),<sup>7</sup> Article 9 of the "US Model Income Tax Convention" (US MC),<sup>8</sup> and Article 4(1) of the Arbitration Convention between the EU Member States.<sup>9</sup> Moreover, a 2011 OECD survey showed that all responding OECD and non-OECD countries "indicate that their legislation establishes a general obligation to comply with the arm's length principle".<sup>10</sup> Some even consider the arm's length principle as having the status of customary international law.<sup>11</sup>

Arm's length pricing, however, depends on markets. Hence problems naturally arise where no sufficiently-established market for unrelated-party transactions exists or where reliable information is not available.<sup>12</sup> Moreover, the transactional relationships between associated enterprises may differ from potentially comparable transactions between unrelated parties in important and fundamental ways.<sup>13</sup> In particular, practical difficulties relate to both identifying appropriate comparables and determining how any "integration benefits" (for example, the synergistic cost savings, finance savings) should be apportioned amongst the participating entities<sup>14</sup>; this gives rise to the so-called "continuum price problem", that is, a situation in which the sum of the returns for separate transactions by independent parties is less than the actual return of the combined MNE.<sup>15</sup>

<sup>7</sup>United Nations, Model Double Taxation Convention between Developed and Developing Countries (updated 2011), available at: [http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf) [Accessed November 6, 2013]. For the UN's work on a transfer pricing manual, see the Note by the UN Secretariat, "Transfer Pricing Practical Manual for Developing Countries" (2009) 18 *Tax Mgmt Trans. Pricing Rep.* 714. The UN's *Practical Manual on Transfer Pricing for Developing Countries* has recently been published and is available at: [http://www.un.org/esa/ffd/documents/UN\\_Manual\\_TransferPricing.pdf](http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf) [Accessed November 20, 2013].

<sup>8</sup>US Model Income Tax Convention of November 15, 2006, available at: <http://www.irs.gov/pub/irs-trty/model006.pdf> [Accessed November 6, 2013]. US Model Technical Explanation Accompanying the US Model Income Tax Convention on November 15, 2006 on Art.9 (treating the arm's length principle as a treaty obligation).

<sup>9</sup>Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises [1990] OJ L225/10. The importance of the arm's length principle has also been frequently highlighted by EU institutions. See, e.g. *Company Taxation in the Internal Market* (SEC(2001)1681), 256; Commission of the European Communities (ed.), *Report of the Committee of Independent Experts on Company Taxation—Ruding Report* (1992), 205.

<sup>10</sup>See OECD, *Multi-Country Analysis of Existing Transfer Pricing Simplification Measures* (2011), 9.

<sup>11</sup>C. Thomas, "Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method" (1996) 14(1) *Berkeley Journal of International Law* 99; contra. J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (2010), 288–290.

<sup>12</sup>See also OECD TPG, above fn.1, para.1.13.

<sup>13</sup>See, e.g. H.N. Higinbotham and M.M. Levey, "When Arm's Length Isn't Really Arm's Length: Issues in Application of the Arm's Length Standard" (1998) 26 *Intertax* 235 and following (discussing economies of integration, allocation of functions and risks, ownership of intangibles, non-equivalent bargaining situations, and related party agreements for tax purposes); J. Wittendorff, "The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?" (2011) 62 *TNI* 223, 239–248 (discussing economies of integration, centralised purchasing functions, intangibles, financial transactions, and implicit support).

<sup>14</sup>See, e.g. Higinbotham and Levey, above fn.13; D.L.P. Francescucci, "The Arm's Length Principle and Group Dynamics" (2004) 11 *ITPJ* 55, and following. For a recent attempt to address this issue see OECD, *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (Revised Discussion Draft) (issued on July 30, 2013), paras 18–23.

<sup>15</sup>It will specifically arise in the presence of economies of integration if a one-sided transfer pricing method (i.e. a method where only one party is tested) is used: if, *first*, two different one-sided methods are applied to each of the associated enterprises, there will be an unallocated residual profit attributable to the economies of integration. If, *secondly*, only one one-sided method is applied, the residual profit will be allocated to the non-tested party, so that profit allocation indeed depends on the choice of method. See for a discussion of these issues, e.g. Langbein, above fn.5, 626; Francescucci, above fn.14, 72; Wittendorff, above fn.13, 239–241.

Indeed, the arm's length standard, originally developed in a low tech, bricks-and-mortar economy and while perhaps theoretically sound,<sup>16</sup> is largely viewed as dysfunctional in a globalised, high-tech economic environment, especially with regard to intangibles.<sup>17</sup> On a fundamental level, the basic criticism of the arm's length standard is that a transactional approach does not reflect economic reality. This is because MNEs are usually integrated entities to which each subsidiary contributes and in which typical inefficiencies and duplication are avoided while economies of scale and integration ("synergy rents") are achieved.<sup>18</sup> Hence, the profit of an integrated firm cannot be soundly divided with market prices.<sup>19</sup> Moreover, transfer pricing using the arm's length standard is considered "absurdly complex"<sup>20</sup> and as creating enormous compliance and enforcement costs,<sup>21</sup> while nevertheless leading to widespread opportunities for income shifting.<sup>22</sup>

It hence comes as no surprise that income shifting based on transfer pricing has entered the limelight of the current discussion on base erosion and profit shifting, on a national level (for example, in the UK<sup>23</sup> and the US<sup>24</sup>) as well as on an international level: supported and pushed by

<sup>16</sup> OECD TPG, above fn.1, para.1.14; for an opposing position see Langbein, above fn.5, 627.

<sup>17</sup> E. Chorvat, "Forcing Multinationals to Play Fair: Proposals for a Rigorous Transfer Pricing Theory" (2003) 54 Ala. L. Rev. 1251, 1259–1262; Brauner, above fn.4; R.S. Avi-Yonah, "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation" (2010) 2 WTJ 3, 8; M.C. Durst, "It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws" (2010) 57 TNI 247, and following.

<sup>18</sup> R.S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation" (1995) 15 Va. Tax Rev. 89, 148–150; E.E. Lester, "International Transfer Pricing Rules: Unconventional Wisdom" (1995) 2 ILSA J. Int'l & Comp. L. 283, 295–297; Higinbotham and Levey, above fn.13; H. Hamaekers, "Arm's Length—How Long?" in P. Kirchhof, et al. (eds), *Staaten und Steuern, Festschrift für Klaus Vogel* (2000), 1043, 1052; J. Li, "Global Profit Split: An Evolutionary Approach to International Income Allocation" (2002) 50 CTJ 823, 832; Chorvat, above fn.17, 1259–1262; Francescucci, above fn.14, 55 and following; Brauner, above fn.4; R.S. Avi-Yonah, K.A. Clausing and M.C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split" (2009) 9 Fla. Tax Rev. 497, 501; R.J. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World" (2010) 2 WTJ 291, and following; J.J.A. Burke, "Re-Thinking First Principles of Transfer Pricing Rules" (2011) 30 Va. Tax Rev. 613, 626–627; J. Li, "Soft Law, Hard Realities and Pragmatic Suggestions: Critiquing the OECD Transfer Pricing Guidelines" in W. Schön and K.A. Konrad (eds), *Fundamentals of International Transfer Pricing in Law and Economics* (2012), 71, 82 and following.

<sup>19</sup> H. Luckhaupt, M. Overesch and U. Schreiber, "The OECD Approach to Transfer Pricing: A Critical Assessment and Proposal" in W. Schön and K.A. Konrad (eds), *Fundamentals of International Transfer Pricing in Law and Economics* (2012), 91, 116.

<sup>20</sup> Avi-Yonah, above fn.17, 3, 7; see also Lester, above fn.18, 283, 298; W. Hellerstein, "The Case for Formulary Apportionment" (2005) 12 ITPJ 103, 108; Avi-Yonah, Clausing and Durst, above fn.18, 497, 502.

<sup>21</sup> Avi-Yonah, above fn.18, 150–151; Hamaekers, above fn.18, 1043, 1056–1057; Hellerstein, above fn.20, 103, 109; Brauner, above fn.4; Durst, above fn.17, 247, 252.

<sup>22</sup> Avi-Yonah, above fn.18, 151–152; Lester, above fn.18, 283, 297; Chorvat, above fn.17, 1251, 1253; Hellerstein, above fn.20, 103, 109; Avi-Yonah, Clausing and Durst, above fn.18, 497, 506–507; Durst, above fn.17, 247, 251–252; Avi-Yonah, above fn.17, 3, 6–7; S.C. Morse, "Revisiting Global Formulary Apportionment" (2010) 29 Va. Tax Rev. 593, 597–598. For a review of the empirical literature see Luckhaupt, Overesch and Schreiber, above fn.19, 91 and following.

<sup>23</sup> See, e.g. UK House of Lords Select Committee on Economic Affairs, *Tackling corporate tax avoidance in a global economy: is a new approach needed?* (The Stationery Office, July 31, 2013) HL Paper 48 (1st Report of Session 2013–14).

<sup>24</sup> See, e.g. US Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-27-10, 2010).

the G20,<sup>25</sup> the G8<sup>26</sup> and the EU,<sup>27</sup> the OECD issued a lengthy report on *Addressing Base Erosion and Profit Shifting* on February 12, 2013 (BEPS Report)<sup>28</sup> and a concrete *Action Plan on Base Erosion and Profit Shifting* on July 19, 2013 (Action Plan).<sup>29</sup> Transfer pricing is at the heart of this Action Plan. However, the OECD does not intend to give up on the arm's length principle altogether (and, for example, move to a formulary system),<sup>30</sup> but rather to "fix" the flaws of the current system, noting that

"[i]n the area of transfer pricing, the rules should be improved in order to put more emphasis on value creation in highly integrated groups, tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits".<sup>31</sup>

As the BEPS Report highlights:

"One of the underlying assumptions of the arm's length principle is that the more extensive the functions/assets/risks of one party to the transaction, the greater its expected remuneration will be and *vice versa*. This therefore creates an incentive to shift functions/assets/risks to where their returns are taxed more favorably. While it may be difficult to shift underlying functions, the risks and ownership of tangible and intangible assets may, by their very nature, be easier to shift. Many corporate tax structures focus on allocating significant risks and hard-to-value intangibles to low-tax jurisdictions, where their returns may benefit from a favorable tax regime. Such arrangements may result in or contribute to BEPS."<sup>32</sup>

<sup>25</sup> At its Los Cabos meeting on June 18–19, 2012, the G20 Leaders referred to "the need to prevent base erosion and profit shifting" and stated that they would "follow with attention the ongoing work of the OECD in this area". Thereafter, the G20 finance ministers welcomed the OECD report at their Moscow meeting on February 15–16, 2013 and declared to be "determined to develop measures to address base erosion and profit shifting, take necessary collective actions and look forward to the comprehensive action plan the OECD will present to [them] in July". And at the Moscow meeting on July 19–20, 2013 the G20 finance ministers "fully endorse[d] the ambitious and comprehensive Action Plan submitted at the request of the G-20 by the OECD aimed at addressing base erosion and profit shifting (BEPS) with a mechanism to enrich the Plan as appropriate. We welcome the establishment of the OECD/G20 BEPS project and encourage all interested countries to participate". Finally, the G20 Leaders' Declaration from the Russia G20 Summit in September 2013 fully endorses "the ambitious and comprehensive Action Plan—originated in the OECD—aimed at addressing base erosion and profit shifting with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. Profits should be taxed where economic activities deriving the profits are performed and where value is created".

<sup>26</sup> The 2013 Lough Erne G8 Leaders' Communiqué states that, "[o]n tax avoidance, we support the OECD's work to tackle base erosion and profit shifting".

<sup>27</sup> See the EU Commission's Press Release, *Commissioner Šemeta welcomes G20 Finance Ministers' commitments on new measures to fight tax evasion and avoidance* (MEMO/13/711, July 20, 2013), warmly welcoming "the G20 Finance Ministers' commitments today on concrete measures to better tackle tax evasion and corporate tax avoidance worldwide".

<sup>28</sup> OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing, 2013), 42, available at: <http://www.oecd.org/ctp/beps.htm> [Accessed November 7, 2013].

<sup>29</sup> OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, 2013), available at: <http://dx.doi.org/10.1787/9789264202719-en> [Accessed November 7, 2013].

<sup>30</sup> In defence of the arm's length standard J. Owens, "Myths and Misconceptions About Transfer Pricing And the Taxation of Multinational Enterprises" (2013) 21 Tax Mgmt Trans. Pricing Rep. 1051, and following.

<sup>31</sup> Action Plan, above fn.29, 14.

<sup>32</sup> BEPS Report, above fn.28, 42.

Consequently, the OECD's Action Plan identifies a number of "pressure areas", divided into 15 concrete Actions where international co-operation is needed. As for transfer pricing, substantive issues are addressed by Actions 8 (intangibles), 9 (risk and capital) and 10 (other high-risk transactions),<sup>33</sup> all of which are intended to assure that transfer pricing outcomes are in line with value creation or—phrased differently—to "align taxation and substance"<sup>34</sup>, these Actions should lead to changes in the OECD TPG and possibly in the OECD MC within two years.<sup>35</sup> Moreover, Action 13 deals with transparency and calls for a re-examination of transfer-pricing documentation,<sup>36</sup> which might lead to requirements of value-chain analyses in transfer-pricing documentation to identify—country-by-country—value-creating activities in different industries and under different business models. Indeed, the dissociation of functions, risks, and intangibles over various countries in highly integrated industries has been one major concern for tax administrations and has led to calls for a stronger focus on contribution analyses within the transactional profit methods.<sup>37</sup>

## Aligning transfer pricing outcomes with value creation

### *Fixing the flaws in the current system*

The Action Plan identifies three concrete critical issues within the transfer pricing area, that is, intangibles, allocation of risk and capital, and other "high-risk" transactions. Indeed, it is mainly in these areas that MNEs have been able to use contractual arrangements to move taxable income to low- and zero-tax jurisdictions, that is to create so-called "stateless income".<sup>38</sup> Google's "Double Irish Dutch Sandwich" structure being probably the most prominent example,<sup>39</sup> this form of tax planning can lead to a situation in which income from business activities is subject to tax only in a low- or zero-tax jurisdiction that is neither the source of the factors of production through which the income was derived, nor the domicile of the group's parent company. This outcome is at the heart of the income shifting concerns raised in the Action Plan and its aim to align transfer pricing outcomes with value creation:

"Transfer pricing rules serve to allocate income earned by a multinational enterprise among those countries in which the company does business. In many instances, the existing transfer pricing rules, based on the arm's length principle, effectively and efficiently allocate the income of multinationals among taxing jurisdictions. In other instances, however,

<sup>33</sup> However, also Action 4 (base erosion through interest deductions and other financial payments) touches on transfer pricing.

<sup>34</sup> See OECD, *BEPS Frequently Asked Questions* (2013), 3.

<sup>35</sup> As for Action 8 (intangibles), the Action Plan, above fn.29, sets the timeframe with September 2014 and September 2015, as for Actions 9 (risk and capital) and 10 (other high-risk transactions) the timeframe is September 2015.

<sup>36</sup> See also OECD, *White Paper on Transfer Pricing Documentation* (July 30, 2013), available at: <http://www.oecd.org/ctp/transfer-pricing/white-paper-transfer-pricing-documentation.pdf> [Accessed November 7, 2013].

<sup>37</sup> See G. Steiner, "Aktionsplan der OECD zum BEPS-Report—Konzernbesteuerung, quo vadis?" (2013) 23 SWI 385, 390, referring, *inter alia*, to paras 2.109, 2.112, 2.119 and 2.120 of the OECD TPG, above fn.1.

<sup>38</sup> E.D. Kleinbard, "Stateless Income" (2011) 11 Fla. Tax Rev. 699, and following.

<sup>39</sup> For a description of this structure see, e.g. the example at BEPS Report, above fn.28, 74–76; C. Fuest, et al., *Profit Shifting and "Aggressive" Tax Planning by Multinational Firms: Issues and Options for Reform* (ZEW Discussion Paper No.13-044, July 2013), 3–6.

multinationals have been able to use and/or misapply those rules to separate income from the economic activities that produce that income and to shift it into low-tax environments. This most often results from transfers of intangibles and other mobile assets for less than full value, the over-capitalisation of lowly taxed group companies and from contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties.”<sup>40</sup>

Although neither the BEPS Report nor the Action Plan reveals preconceptions as to the precise nature of the changes that may be required to address these issues or a concrete approach towards “value creation”, the Action Plan notes that the focus is not on a conceptual change but rather

“to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalisation”.

It also notes, however, that the measures may be “either within or beyond the arm’s length principle”.<sup>41</sup> This clearly indicates that the OECD does not exclude changes of Article 9 of the OECD MC that would lead to a deviation from the arm’s length principle, which in turn would acknowledge that this leading principle does not have universal application and would undermine its importance.

Moving even one step further, the current shortcomings have led commentators to propose alternative approaches to transfer pricing,<sup>42</sup> hybrid forms or simplifications involving both the arm’s length standard and formulary apportionment,<sup>43</sup> or a move to global formulary apportionment.<sup>44</sup> As to the latter, conceptually, the difference between the arm’s length standard

<sup>40</sup> Action Plan, above fn.29, 20.

<sup>41</sup> Action Plan, above fn.29, 20.

<sup>42</sup> See, e.g. Chorvat, above fn.17.

<sup>43</sup> See, e.g. Francescucci, above fn.14, 235 and following (composite approach using a multilateral residual profit split method); M.C. Durst, “A Statutory Proposal for US Transfer Pricing Reform” (2007) 46 *TNI* 1041, 1044–1045 (allocation of market-return based on the cost-plus method and formulary apportionment of the remainder); N. Herzig, M. Teschke and C. Joisten, “Between Extremes: Merging the Advantages of Separate Accounting and Unitary Taxation” (2010) 38 *Intertax* 334 (combination of separate accounting with aspects of unitary taxation); Avi-Yonah, Clausing and Durst, above fn.18, 497 and following, and Avi-Yonah, above fn.17, 3, 16–17 (formula-based residual profit split); Luckhaupt, Overesch and Schreiber, above fn.19, 91 and following (pooling transactions and allocating profits along the value added chain according to easily observable apportionment factors).

<sup>44</sup> See, with further references, the discussion by, e.g. Langbein, above fn.5, 625 and following; L.M. Kauder, “Intercompany Pricing and Section 482: A Proposal to Shift from Uncontrolled Comparables to Formulary Apportionment Now” (1993) 58 *TN* 485, and following; J.R. Hellerstein, “Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment” (1993) 60 *TN* 1131; Avi-Yonah, above fn.18, 153 and following; Lester, above fn.18, 283, 303–304; Hamaekers, above fn.18, 1043, 1061–1062; K. Sadiq, “Unitary Taxation—The Case for Global Formulary Apportionment” (2001) 55 *BIFD* 275, and following; C.E. McLure, Jr., “Replacing Separate Entity Accounting and the Arms Length Principle with Formulary Apportionment” (2002) 56 *BIFD* 586, and following; Li, above fn.18, 823, and following (global profit split); Hellerstein, above fn.20, 103 and following; F. Vincent, “Transfer Pricing and Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Splits (Just Don’t Say Formulary Apportionment)” (2005) 53 *CTJ* 409, and following; M. Kobetsky, “The Case for Unitary Taxation of International Enterprises” (2008) 62 *BIT* 201, and following (discussing a multilateral tax treaty); Brauner, above fn.4, 79, 159–164; Durst, above fn.17, 247 and following; for critical analyses of formulary apportionment see, e.g. R. Ackerman and E. Chorvat, “Modern Financial Theory and Transfer Pricing” (2002) 10 *Geo. Mason L. Rev.* 637, and following; J. Roin, “Can the Income Tax Be Saved—The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment” (2008) 61 *TLR* 169, and following; Morse, above fn.22, 593 and following (discussing destination sales-based formulary apportionment); H.K. Kroppen, R. Dawid, and R. Schmidke,

and global formulary apportionment is that the arm's length standard starts with treating each entity in an affiliated group as separate taxpayers, hypothetically dealing with each other at arm's length, whereas the formulary approach starts with the entire affiliated group as one unitary enterprise.<sup>45</sup> Indeed, the EU Commission is currently pursuing such a formula-based regime in its proposal for a "Common Consolidated Corporate Tax Base" (CCCTB) as a solution to transfer pricing problems within the EU, with little progress, however, at the level of the Council so far.<sup>46</sup> Until recently the OECD has taken a rather clear position "that moving to a system of formulary apportionment of profits is not a viable way forward",<sup>47</sup> as it is supposedly not acceptable in theory, implementation or practice,<sup>48</sup> and calls for maintaining the arm's length principle as the international consensus.<sup>49</sup> The openness, however, of the Action Plan to go "beyond the arm's length principle" implies that

"[t]ax administrations should be prepared to 'stretch' the profit-based methods so that tailored profit-based formulae can be used to allocate profits in certain circumstances".<sup>50</sup>

Along those lines, it has already been argued that the traditional arm's length standard in the form of the comparable uncontrolled price method and global formulary methods are not polar extremes, but rather parts of a continuum,<sup>51</sup> and that therefore

"[g]overnment decisions on where they want to be on this spectrum should be guided by what approach is likely to deliver the minimum amount of friction and compliance costs and a sharing of the tax base that accurately reflects the economic activities carried out in each jurisdiction."<sup>52</sup>

### *Intangibles (Action 8)*

Transfer pricing for intangible property is an increasingly important area in cross-border taxation and presents a number of specific problems.<sup>53</sup> When it comes to the kind of income shifting

<sup>45</sup> "Profit Split, the Future of Transfer Pricing?" in W. Schön, and K.A. Konrad (eds), *Fundamentals of International Transfer Pricing in Law and Economics* (2012), 267 and following; Owens, above fn.30, 1051, 1053–1054.

<sup>46</sup> Avi-Yonah, above fn.18, 92–93.

<sup>47</sup> The current status of the CCCTB Proposal is that the subsidiary analysis by the National Parliaments (Art.5(3) EUT) has been closed (no reconsideration necessary), the opinion of the European Economic and Social Committee has been given ([2012] OJ C24/63) and the Legislative Resolution of the European Parliament has been issued (P7\_TA(2012)0135 of April 19, 2012). Currently, Council is conducting technical issues, with a compromise proposal being published in Doc. 8387/12 FISC 49 and Doc. 8790/12 FISC 52 (April 16, 2012) (reprinted in (2012) 10 *Highlights & Insights on European Taxation* 5, and following, with comments by Nou-wen and Van de Streek) and in Doc. 9180/13 FISC 80 (May 2, 2012). It should, however, be noted that the German Government's analysis has taken an outspoken position against consolidation and optionality; see BT-Drs 17/5748 of May 5, 2011.

<sup>48</sup> Action Plan, above fn.29, 14.

<sup>49</sup> See the discussion in OECD TPG, above fn.1, paras 1.16–1.31.

<sup>50</sup> OECD TPG, above fn.1, paras 1.14–1.15.

<sup>51</sup> Owens, above fn.30, 1051, 1054.

<sup>52</sup> Avi-Yonah, above fn.18, 91–94; Li (2012), above fn.18, 71, 81.

<sup>53</sup> Owens, above fn.30, 1051, 1054.

<sup>54</sup> For detailed discussions of the transfer pricing issues with respect to intangibles, see the contributions in IFA (ed.), *Transfer pricing and intangibles*, CDFI Vol.92a (2007), and, e.g. M. Markham, *The Transfer Pricing of Intangibles* (2005); Brauner, above fn.4; T. Rosembuj, "Intangible Assets and Transfer Pricing" in L. Hinnekens and P. Hinnekens (eds), *A Vision of Taxes within and outside European Borders*, *Festschrift Frans Vanis-tendael* (2008), 756 and

addressed in the Action Plan, the basic concerns arise from intragroup contracts with regard to licences and other transfers of rights to intangible property in which a “cash-box” subsidiary, perhaps located in a low-tax jurisdiction, agrees to bear the risk of further development and receives the right to income from future exploitation of the intangibles,<sup>54</sup> but conducts little or no additional business activity and is typically limited to the making of financial contributions (for example, using funds contributed by the parent company).<sup>55</sup> A typical structure is a cost contribution arrangement (CCA),<sup>56</sup> that is, in US-terminology a “cost sharing agreement”,<sup>57</sup> where one party contributes the right to use existing intangible property for further research and development (that is, a platform contribution), whereas the other party makes a buy-in payment to acquire these rights and also makes further contributions to fund research and development conducted by the parent company; the rights to the asset being developed and the costs pertaining are then shared based on the expected profit potential of the rights. This raises not only issues with regard to the arm’s length amount of buy-in payments, but also with regard to the question of whether the mere funding of research and development without the assumption of further risks and functions would entitle the funder to more than a risk-adjusted rate of anticipated return on the capital investment. Likewise in “ordinary” licensing situations, the fundamental transfer pricing question is whether sufficient profits have been allocated to each party to compensate adequately for the contribution of resources to the supply chain and the assumption of risks in it. Against this background, the Action Plan puts emphasis on intangibles and states as Action 8:

“Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.”<sup>58</sup>

Progress has already been made during the past few years on the OECD’s work on updating Chapter VI of the OECD TPG, which contains “special considerations for intangibles”.<sup>59</sup> Indeed,

following; J. Wittendorff, “Valuation of Intangibles under Income-Based Methods” (2010) 17 ITPJ 323, and following, and 383 and following.

<sup>54</sup> There is also the deeper issue that under the current set of OECD guidance the transfer of the business opportunity (“profit potential”) itself, e.g. that a subsidiary may build a business by developing a market, does not constitute the transfer of intangible property and therefore does not require compensation under arm’s length rules. See OECD TPG, above fn.1, para.9.65 and the criticism voiced by M.C. Durst, “A Two-Option Compromise for Intangibles Guidelines” (2012) 68 TNI 1123, 1124.

<sup>55</sup> See Durst, above fn.54, 1123, 1123–1124.

<sup>56</sup> OECD TPG, above fn.1, Ch.VIII.

<sup>57</sup> US Treas. Reg. § 1.482–7 (IRB 2012-12 of March, 19 2012).

<sup>58</sup> Action Plan, above fn.29, 20.

<sup>59</sup> See Revised Discussion Draft, above fn.14, and preceding this the OECD’s Discussion Draft, *Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Provisions and Related Provisions* (2012), which itself was based on the Scoping Document, *Transfer Pricing and Intangibles* (January 25, 2011). For analysis see, e.g. Durst, above fn.54, 1123 and following; J. Wittendorff, “Shadowlands: The OECD on Intangibles” (2012) 67 TNI 935, and following. Indeed, the Revised Discussion Draft notes that the “work on intangibles is listed as one of the BEPS actions in that Action Plan” and that this work “is closely related to other BEPS actions contained in the

the *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (Revised Discussion Draft), which was issued on July 30, 2013, takes major steps in aligning transfer pricing outcomes with—what the states represented in the OECD view as—“value creation”. First, in line with the Action Plan’s call for “adopting a broad and clearly delineated definition of intangibles”,<sup>60</sup> the Revised Discussion Draft sets out to define intangibles separately from property law or accounting rules as

“something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”.<sup>61</sup>

This includes *inter alia* patents, know-how and trade secrets, trademarks, trade names and brands, rights under contracts and government licences, licences and similar rights in intangibles, goodwill and ongoing concern value, but excludes group synergies and market specific characteristics (for example, location savings, assembled workforce, market premium).<sup>62</sup> While the OECD takes the position that market specific characteristics should be taken into account through the comparability analysis, this issue will likely raise further debate, as, for example, China is of the view that profits arising from location specific advantages should be allocated according to one of the transfer pricing methods, including a profit split.<sup>63</sup>

Secondly, the Revised Discussion Draft deals with the allocation of an “intangible related return” and hence addresses the Actions Plan’s call for

“ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation.”

The Revised Discussion Draft tries to align pricing with value creation by considering legal ownership of an intangible as being a mere starting point in the analysis and focusing on the relevant contributions by each entity of an MNE to the anticipated value of the intangibles through its functions performed, assets used, and risks assumed.<sup>64</sup> Hence, the legal owner of an intangible is entitled to all returns attributable to the intangible only if, in substance, it performs and controls all of the important functions<sup>65</sup> related to the development, enhancement, maintenance and protection of the intangibles; controls other functions outsourced to independent enterprises or associated enterprises and compensates those functions on an arm’s length basis; provides all

Action Plan”; moreover, “[s]ome of the text and examples contained in this Revised Discussion Draft raise BEPS issues that the OECD intends to address through the various actions contained in the Action Plan”.

<sup>60</sup> Action Plan, above fn.29, 20.

<sup>61</sup> Revised Discussion Draft, above fn.14, para.40. For a recent and comprehensive analysis see J.S. Wilkie, “The Definition and Ownership of Intangibles: Inside the Box? Outside the Box? What is the Box?” (2012) 4 WTI 222, and following.

<sup>62</sup> Revised Discussion Draft, above fn.14, paras 52–64.

<sup>63</sup> See Chs 10.3.3 and 10.3.5 of “China Country Practice” in the UN’s *Practical Manual on Transfer Pricing for Developing Countries*, above fn.7, 374 and following.

<sup>64</sup> Revised Discussion Draft, above fn.14, para.73.

<sup>65</sup> Specifically design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible; see Revised Discussion Draft, above fn.14, para.79.

assets necessary to the development, enhancement, maintenance, and protection of the intangibles; and bears and controls all of the risks and costs related to the development, enhancement, maintenance and protection of the intangible.<sup>66</sup> Conversely, to the extent that one or more members of the MNE group other than the legal owner perform functions, use or contribute assets, or assume risks or costs related to the development, enhancement, maintenance, and protection of the intangible, returns attributable to the intangible must accrue to such other members through arm's length compensation reflecting their anticipated contribution to intangible value.<sup>67</sup> This means, for example, that the mere funding of research and development without the assumption of further risks and functions would entitle the funder to no more than a risk-adjusted rate of anticipated return on the capital investment.<sup>68</sup>

Thirdly, “transfers of hard-to-value intangibles” have been the subject of an ongoing debate, and the Action Plan calls for “developing transfer pricing rules or special measures”<sup>69</sup> for these transactions. Based on a rejection of hindsight and respecting ex ante valuation, the current OECD TPG<sup>70</sup> on issues of highly uncertain valuation favour a case-by-case analysis and do not authorise adjustments to, for example, royalty rates or purchase prices solely because the actual profits generated by the transferred intangibles differ—even substantially differ—from those projected ex ante.<sup>71</sup> However, the main question is to determine whether the valuation was indeed so uncertain at the outset so that the parties at arm's length would have required a price adjustment mechanism, while

“the mere existence of uncertainty at the time of the transaction should not require an ex-post adjustment without a consideration of what third parties would have done or agreed between them”.<sup>72</sup>

The Action Plan now explicitly addresses “transfers of hard-to-value intangibles”,<sup>73</sup> that is, dispositions at a point in time when the intangible does not yet have an established value (for example, pre-exploitation), and calls for the development of pertaining “transfer pricing rules or special measures”. The main concern seems to be situations where there is a significant gap between the level of expected future profits that was taken into account in the valuation made at the time of the sale transaction and the actual profits derived by the transferee from the exploitation of the intangibles thus acquired. This problem, however, is not new and has been

<sup>66</sup> Revised Discussion Draft, above fn.14, para.89.

<sup>67</sup> Revised Discussion Draft, above fn.14, para.90.

<sup>68</sup> Revised Discussion Draft, above fn.14, para.84.

<sup>69</sup> Action Plan, above fn.29, 20.

<sup>70</sup> OECD TPG, above fn.1, paras 6.28–6.35 and 9.87–9.88. The Revised Discussion Draft, above fn.14, paras 199–206, has retained the language of the 2010 Guidelines on hard to value intangibles, noting, however, that “[t]he BEPS Action Plan suggests that one area for future BEPS related work involves the transfer pricing treatment of hard to value intangibles” and that this “will include a detailed review of the language and approach currently outlined in the Transfer Pricing Guidelines on this topic”, so that “it is anticipated that substantial work will be focused on this topic in coming months”.

<sup>71</sup> See A. Bullen, *Arm's Length Transaction Structures* (IBFD, 2011), 672.

<sup>72</sup> OECD TPG, above fn.1, para.9.88; for a critical analysis of the OECD's approach see J. Wittendorff, “The Transactional Ghost of Article 9(1) of the OECD Model” (2009) 63 BIT 107, 120–122; Wittendorff, above fn.11, 689–694; Wittendorff, above fn.53, 83, 399.

<sup>73</sup> Action Plan, above fn.29, 20.

addressed by the US beginning in the late 1980s: based on the 1988 US Treasury White Paper,<sup>74</sup> the 1994 US transfer pricing regulations<sup>75</sup> address transfer pricing methods as well as the “commensurate with income standard” for intangibles, which was introduced in IRC § 482 by the 1986 Act.<sup>76</sup> The “commensurate with income standard” requires that the consideration for intangible property transferred in a controlled transaction be commensurate with the income attributable to the intangible. This means that the subsequent annual performance of those intangibles is used to determine whether the consideration received for the initial transfer was at arm’s length, and periodic adjustments are made to reflect such performance unless certain exceptions are met (the so-called “super royalty” concept).<sup>77</sup> While two OECD Task Force Reports, issued in 1992<sup>78</sup> and 1993,<sup>79</sup> were critical of the “commensurate with income standard”,<sup>80</sup> it now seems to be a possible route to address these issues comprehensively at the OECD level.<sup>81</sup> Also, since the Action Plan explicitly mentions “special measures” that can go “beyond the arm’s length principle”,<sup>82</sup> the possible hurdle that the “commensurate with income standard” might be incompatible with the arm’s length principle could be overcome by an amendment to Article 9 of the OECD MC.<sup>83</sup>

<sup>74</sup> Department of the Treasury and IRS, *A Study of Intercompany Pricing under Section 482 of the Code* (Notice 88-123, 1988-2 C.B. 458, 1988).

<sup>75</sup> 59 Fed. Reg. 34971 (1994), T.D. 8552, 1994-2 C.B. 93.

<sup>76</sup> US Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2561, and following. A similar rule is found in German tax law since 2008; see, e.g. W. Kessler and R. Eicke, “Out of Germany: The New Function Shifting Regime” (2007) 48 TNI 53, and following; see also Wittendorff, above fn.11, 684–689. Moreover, in Canada, paras 150–151 of the Canadian Circular 87-2R of September 27, 1999 note with reference to § 247(2)(b) of the Canadian Income Tax Act 1985 and the OECD TPG, above fn.1, that long-term agreements between non-arm’s length parties for the right to use intangibles will be reviewed and may be recharacterised under certain conditions.

<sup>77</sup> See US Treas. Reg. § 1.482-4(f)(2)(i) and (ii); see also the US Chief Counsel Memorandum of March 27, 2007, AM-2007-007 (concerning “Taxpayer Use of Section 482 and the Commensurate With Income Standard”); for analyses of the CWI standard see, e.g. R.G. Clark, “Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonized Income Allocation Measures from Multinational Cacophony” (1993) 42 Am. U. L. Rev. 1155, 1177 and following; Wittendorff, above fn.11, 677–684.

<sup>78</sup> OECD, *Tax Aspects of Transfer Pricing within Multinational Enterprises: The United States Proposed Regulations* (1993).

<sup>79</sup> OECD, *Intercompany Transfer Pricing Regulations under US Section 482 Temporary and Proposed Regulations* (1993).

<sup>80</sup> See also Wittendorff, above fn.11, 45–46 and 104–105.

<sup>81</sup> See also Fuest, et al., above fn.39, 14 (an adequate valuation of intangible assets and relating royalty payments “can be done by implementing an adjustment clause in the national tax code which provides tax authorities with the opportunity to levy additional exit tax if the earnings potential turns out to be substantially higher than initially expected”).

<sup>82</sup> Action Plan, above fn.29, 20.

<sup>83</sup> See for a critical discussion of compatibility with Art.9 OECD MC, above fn.4, e.g. G. Maisto, “General Report” in IFA (ed.), *Transfer pricing in the absence of comparable market prices*, CDFI Vol.77a (1992), 19, 55; Clark, above fn.77, 1155, 1177; Kessler and Eicke, above fn.76, 53, 56; Brauner, above fn.4, 79, 100–101; Wittendorff, above fn.72, 107, 121; Wittendorff, above fn.11, 167 and 689–694; J. Wittendorff, “The Arm’s-Length Principle and Fair Value: Identical Twins or Just Close Relatives?” (2011) 62 TNI 223, 227. See, however, for the US position on the compatibility with the arm’s length standard US Tech. Expl. on Art.9(1) of the 2006 US MC (concerning the “commensurate with income” standard); see also the US Chief Counsel Memorandum of March 27, 2007, AM-2007-007; see also Treas. Reg. § 1.482-4(f)(2)(i) (adjustments under commensurate with income rule “shall be consistent with the arm’s length standard”).

Fourthly, and finally, the Action Plan calls for “updating the guidance on cost contribution arrangements”.<sup>84</sup> Currently, Chapter VIII of the OECD TPG provides supplementary guidance for situations in which the resources and skills of two or more associated enterprises (along, perhaps, with independent enterprises) are pooled and the consideration received is, in whole or in part, the reasonable expectation of mutual benefits.<sup>85</sup> A frequently-encountered type of such “cost contribution arrangement” (CCA) is an arrangement for the joint development of intangibles,<sup>86</sup> although the guidance in the OECD TPG—unlike the US approach to “cost sharing agreements”<sup>87</sup>—is not limited to intangibles and covers “any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services”.<sup>88</sup> Within the guidance on cost contribution arrangements, two issues have been notorious for controversy; these are, the valuation of “buy-in payments” and the extent of the shared cost pool,<sup>89</sup> with the former being of particular concern with respect to income shifting. Again, the OECD might draw inspiration from developments in the US, which has recently established its position on this issue: using the “income method” for determining the initial “buy-in payments” in—what the US IRS considers to be—“typical” cost sharing scenarios in which the US participant owns all the existing intangible property and employs all the technical workforce and decision makers, and the foreign participant is a simple cash box. Under this method, the appropriate “buy-in payments” are determined by comparing a controlled participant’s expected results under the cost sharing agreements to its expected results under its best realistic alternative,<sup>90</sup> the latter being likely to be a situation where one participant incurs all the intangible property development costs and licenses the intangible property to the other participant or participants. This approach—technically implemented through a comparison of discounted expected operating income<sup>91</sup>—sets the “buy-in payment” so that the “cash box” subsidiary is left indifferent between participating in the cost sharing agreement and simply licensing the intangible property. Moreover, economically, the US approach assumes that an integrated enterprise’s financial results will not be affected by its decision as to how to split intangible property ownership within the MNE.

#### *Risks and capital (Action 9)*

Naturally, the assumption of risks or the funding of investments by a group member is trailed by the right to an increased allocation of income from the group’s business activities, that is, the

<sup>84</sup> Action Plan, above fn 29, 20.

<sup>85</sup> OECD TPG, above fn.1, para.8.5; for analyses see, e.g. Wittendorff, above fn.11, 537–592.

<sup>86</sup> OECD TPG, above fn.1, para.8.6; see also the OECD Document, *Transfer Pricing and Intangibles: Scope of the OECD Project*, paras 27–28 (approved by the Committee on Fiscal Affairs on January 25, 2011).

<sup>87</sup> US Treas. Reg. § 1.482-7 (IRB 2012-12 of March 19, 2012).

<sup>88</sup> OECD TPG, above fn.1, para.8.7.

<sup>89</sup> For a discussion of the US approach and relevant case law—especially the decisions in *Xilinx Inc. v Commissioner* (US Tax Court of August 30, 2005, 125 TC 4, and eventually US Court of Appeals Ninth Circuit of March 22, 2010, 598 F.3d 1191) and *Veritas Software Corp v Commissioner* (US Tax Court of December 9, 2009, 133 TC 14)—e.g. H.A. Keates, R. Muylle and D.R. Wright, “Temporary Cost Sharing Regulations: A Comment” (2009) 16 ITPJ 166; Y. Brauner, “Cost Sharing and the Acrobatics of Arm’s Length Taxation” (2010) 38 *Intertax* 554, and following; Wittendorff, above fn.11, 537–592; for a survey of the US developments on cost sharing see, e.g. I. Benshalom, “Sourcing the Unsourceable: The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions” (2007) 26 Va. Tax Rev. 631, and following.

<sup>90</sup> US Treas. Reg. § 1.482-7(g)(4)(i)(A).

<sup>91</sup> US Treas. Reg. § 1.482-7(g)(4)(i)(A).

right to future income. Within a MNE, risks are assigned by contracts, and the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties.<sup>92</sup> Indeed, within MNEs risks may be assigned among the parties by contractual arrangements, which should be respected by tax administrations subject to what is said in the OECD TPG on the importance of the economic substance of the transaction<sup>93</sup> and the exceptional circumstances under which a transaction need not be recognised by a tax administration<sup>94 95</sup> This also means that for transfer pricing purposes risks need not necessarily be aligned with capital allocation or people functions.<sup>96</sup> The OECD, however, calls this adherence to the contractual allocation into question, noting in the BEPS Report that

“the Guidelines are perceived by some as putting too much emphasis on legal structures (as reflected, for example, in contractual risk allocations) rather than on the underlying reality of the economically integrated group”.<sup>97</sup>

Dealing with this issue, the BEPS Report moreover states:

“At a fundamental level they raise the question of how risk is actually distributed among the members of a MNE group and whether transfer pricing rules should easily accept contractual allocations of risk. They also raise issues related to the level of economic substance required to respect contractual allocations of risk, including questions regarding the managerial capacity to control risks and the financial capacity to bear risks. Finally, the question arises as to whether any indemnification payment should be made when risk is shifted between group members.”<sup>98</sup>

The Action Plan seems to go even further, stating with regard to the allocation of risks and capital in Action 9:

“Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense deductions and other financial payments.”<sup>99</sup>

It should be noted that the issue of risk allocation has been addressed quite recently by the OECD in the context of business restructurings.<sup>100</sup> Such business restructurings often involve a

<sup>92</sup> OECD TPG, above fn.1, para.1.52.

<sup>93</sup> OECD TPG, above fn.1, paras 1.47–1.54.

<sup>94</sup> OECD TPG, above fn.1, paras 1.65–1.66.

<sup>95</sup> See also OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (2010 Report) (July 22, 2010), para.68.

<sup>96</sup> See, e.g. OECD TPG, above fn.1 para.9.21.

<sup>97</sup> BEPS Report, above fn.28, 42.

<sup>98</sup> BEPS Report, above fn.28, 42–43.

<sup>99</sup> Action Plan, above fn.29, 20.

<sup>100</sup> The topic of business restructurings was also discussed by the US Joint Committee on Taxation in 2010, though with a different focus; see US Joint Committee on Taxation, *Present Law and Background related to Possible Income Shifting and Transfer Pricing* (JCX-37-10, July 20, 2010), and for a comparative and critical discussion of the OECD

cross-border centralisation not only of intangible assets but also of risks with a profit potential attached to them, for example, the conversion of fully-fledged distributors into limited-distributors or commissionaires or the conversion of fully-fledged manufacturers into contract- or toll-manufacturers.<sup>101</sup> These situations raise a number of transfer pricing issues,<sup>102</sup> and the discussion about these has been especially driven by the introduction of statutory rules on the transfer of functions in Germany with effect from 2008.<sup>103</sup> At the OECD level, the topic was originally dealt with in the *2008 Discussion Draft on the Transfer Pricing Aspects of Business Restructurings*<sup>104</sup> which led to the addition of a new Chapter IX in the OECD TPG in 2010. That new chapter addresses four sets of transfer pricing issues arising from business restructuring, among them the circumstances in which tax authorities may challenge the purported contractual allocation of risks between related parties in the context of Article 9 of the OECD MC<sup>105</sup> and the issue of compensation payments for the restructuring transaction itself.<sup>106</sup> As for the contractual allocation of risk, in the absence of comparables the OECD TPG's focus is on whether the party assuming the risk has greater control over, and has the financial capacity to bear, that risk.<sup>107</sup> This is not a particularly high threshold: "control" over risk in this context refers to the capacity to make decisions to take on the risk and decisions on whether and how to manage the risk, internally or using an external provider<sup>108</sup>; the financial capacity to bear risk means to have the capacity to bear the consequences of the risk should it materialise or that a mechanism to cover it is put in place (for example, insurance).<sup>109</sup>

It remains to be seen whether and to what extent this approach will be maintained and refined in the future or whether the transfer pricing guidance will move in the direction of the "Authorised OECD Approach" (AOA) for profit allocation involving permanent establishments (PEs) under Article 7 of the OECD MC, which is viewed by some as an approach that would better align returns with value creation and hence a possible inspiration for transfer pricing reform. The AOA puts the emphasis on the "identification of significant people functions relevant to the assumption

and JCT statements see R.T. Ainsworth and A.B. Shact, *Transfer Pricing & Business Restructurings—Intangibles, Synergies and Shelters* (Boston University School of Law Working Paper No.11-24, June 3, 2011).

<sup>101</sup> OECD TPG, above fn.1, para.9.2.

<sup>102</sup> For analyses of the transfer pricing treatment of business restructurings, see the contributions in IFA (ed.), *Cross-border business restructuring*, CDFI Vol.96A (2011), and in A. Bakker, *Transfer Pricing and Business Restructurings* (2009).

<sup>103</sup> For analyses of these rules also in light of Art.9 OECD MC, above fn.4, see, e.g. G. Frotscher and A. Oestreicher, "The German Approach to Taxing Business Restructurings: An Arm's Length Ahead?" (2009) 37 *Intertax* 375, and following. The German Ministry of Finance has provided extensive guidance; see German Administrative Principles—Business Restructurings of October 13, 2010, BMF IV B 5 – S 1341/08/10003, *BSiBl* I. 774 (2010) (English translation published in (2011) 18 *ITPJ* 65).

<sup>104</sup> OECD Discussion Draft 2008: *Transfer Pricing Aspects of Business Restructurings*, available at: [www.oecd.org/dataoecd/59/40/41346644.pdf](http://www.oecd.org/dataoecd/59/40/41346644.pdf) [Accessed November 20, 2013].

<sup>105</sup> OECD TPG, above fn.1, paras 9.10–9.47.

<sup>106</sup> OECD TPG, above fn.1, paras 9.48–9.122.

<sup>107</sup> OECD TPG, above fn.1, paras 9.22–9.38; see also, e.g. Wittendorff, above fn.11, 413–414. See, e.g. H.-K. Kroppen and J.C. Silva, "General Report" in IFA (ed.), *Cross-border business restructuring*, CDFI Vol.96A (2011), 17, 49–50; for a detailed discussion on the transactional adjustment aspects see Wittendorff, above fn.11, 168–176; Bullen, above fn.71, 511 and following.

<sup>108</sup> OECD TPG, above fn.1, paras 9.23–9.28.

<sup>109</sup> OECD TPG, above fn.1, paras 9.29–9.32.

of risks, and the attribution of risks to the permanent establishment”,<sup>110</sup> that is, the permanent establishment is considered as assuming any risks of the overall enterprise

“for which the significant people functions relevant to the assumption of risk are performed by the personnel of the PE at the PE’s location”.<sup>111</sup>

Likewise, under the AOA, the PE is treated as having an appropriate amount of capital in order to support the functions it performs, the assets it uses and the risks it assumes.<sup>112</sup> Consequently, the amount and nature of the risks assumed by the PE also affects the amount of capital that needs to be (and can be) attributed to the PE.<sup>113</sup> In short, under the AOA risk follows functions and capital follows risk. Needless to say, however, that an approach that would require an arm’s length determination of capital based on risks and functions and hence a possible re-allocation of “excess capital” between separate legal entities would embark on a slippery slope with all kinds of theoretical and practical problems and with the potential pitfall that, quite contrary to the OECD’s intention, people and functions could eventually follow risks and capital to low-tax jurisdictions.

#### *Other high-risk transactions (Action 10)*

The OECD TPG currently acknowledge that associated enterprises may engage in transactions that independent enterprises would not undertake,<sup>114</sup> and stress that

“it should not be assumed that the conditions established in the commercial and financial relations between associated enterprises will invariably deviate from what the open market would demand”.<sup>115</sup>

Moreover, the OECD TPG observe that the fact that independent entities do not enter into certain transactions does not mean that these transactions are not on arm’s length terms.<sup>116</sup> However, such transactions have raised some concerns from the perspective of tax administrations and are addressed in Action 10 of the Action Plan as “other high-risk transactions” that warrant attention:

“Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.”<sup>117</sup>

<sup>110</sup> See Art. 7 No.21 of the OECD MC, above fn.4, Comm. 2010.

<sup>111</sup> 2010 Report, above fn.95, para.68.

<sup>112</sup> 2010 Report, above fn.95, paras 107 and following.

<sup>113</sup> 2010 Report, above fn.95, para.71.

<sup>114</sup> OECD TPG, above fn.1, para.1.11.

<sup>115</sup> OECD TPG, above fn.1, para.1.5.

<sup>116</sup> OECD TPG, above fn.1, para.1.11.

<sup>117</sup> Action Plan, above fn.29, 20–21.

The Action Plan calls for “adopting transfer pricing rules or special measures”<sup>118</sup> for a range of issues involving transactions which would not, or would only very rarely, occur between third parties. Such transactions clearly raise problems with regard to the administrative burdens for the taxpayer and tax administrations,<sup>119</sup> as third-party data on such transactions will by definition hardly be available. Hence, despite the OECD TPG’s preference for an empirical approach, a hypothetical approach, using the OECD TPG’s analytical tools, principles, and methods, may be best suited “to determine whether the conditions in the controlled transaction are conditions that would have been adopted between independent parties under similar circumstances” and that “it may be appropriate, in relevant circumstances, to use a [profit-split method] with no comparables data”.<sup>120</sup> Moreover, on the level of the comparability analysis, the OECD stresses that independent parties who are dealing at arm’s length would each compare the options realistically available (including “no action” at all) to them, and will only enter into the transaction “if they see no alternative that is clearly more attractive.”<sup>121</sup>

It should be highlighted that Action 10 also calls for a clarification of “the circumstances in which transactions can be recharacterised”<sup>122</sup> and raises the sensitive issue of non-recognition of a taxpayer’s chosen structure by tax administrations. A footnote in the Revised Discussion Draft may moreover imply that some countries seek more leeway to disregard transactions that “would not normally occur between independent enterprises”, especially with regard to transfers of intangibles.<sup>123</sup> The direction of this new guidance remains to be seen. It must, however, be noted that the current OECD TPG already contain a quite reasonable set of tools to balance the interests between tax administrations and taxpayers. Indeed, the OECD TPG currently suggest that, as a general rule, a transfer pricing evaluation “should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them” (the “as structured principle”),<sup>124</sup> which also finds support in the wording of Article 9 of the OECD MC.<sup>125</sup> This limits the ability

<sup>118</sup> Action Plan, above fn.29, 20.

<sup>119</sup> OECD TPG, above fn.1, para.1.12.

<sup>120</sup> *Response of the Committee on Fiscal Affairs to the Comments received on the September 2009 Draft Revised Chapters I-III of the Transfer Pricing Guidelines* (2010), para.21.

<sup>121</sup> OECD TPG, above fn.1, para.1.34; Revised Discussion Draft, above fn.14, paras 128–132; see also, e.g. Australian Taxation Ruling 94/14 of May 31, 1994 para.66, and Australian Taxation Ruling 97/20 of November 5, 1997 para.2.4.

<sup>122</sup> Action Plan, above fn.29, 20–21.

<sup>123</sup> See Revised Discussion Draft, above fn.14, footnote 5 at 63.

<sup>124</sup> OECD TPG, above fn.1, para.1.64; see also OECD, *Transfer Pricing and Multinational Enterprises* (1979), para.23; cf. e.g. the Canadian Circular 87-2R of September 27, 1999 para.43; Australian Taxation Ruling 97/20 of November 5, 1997 paras 2.71–2.72; for extensive analyses see F.M. Horner, “International Cooperation and Understanding: What’s New About The OECD’s Transfer Pricing Guidelines” (1996) 50 U. of Miami L. Rev. 577, 581–582; Wittendorff, above fn.11, 332–334; G. Liaugminaitė, “Recognition of the Actual Transactions Undertaken” (2010) 17 ITPJ 107, and following; Bullen, above fn.71. The “as structured principle” is supplemented by the ex-ante approach, i.e. a rejection of the use of hindsight; see Bullen, above fn.71, 305–322.

<sup>125</sup> Although the notion of “conditions” in Art.9(1) is not per se limited to prices and other valuation elements (e.g. margins), the different references in Art.9(1) to the associated enterprises’ (i.e. “their”) commercial and financial relations and “those conditions” suggests that only the “made or imposed” price or other types of valuation conditions—but not the underlying transactions themselves (i.e. the commercial and financial relations)—should be the object of an adjustment. See F.C. De Hosson, “Codification of the Arm’s Length Principle in the Netherlands Corporate Income Tax Act” (2002) 30 *Intertax* 189, 195; Wittendorff, above fn.72, 107, 116; Wittendorff, above fn.11, 152; for a critical analysis of this textual argument see Bullen, above fn.71, 113–115.

of domestic tax administrations to disregard a controlled transaction as actually undertaken and to substitute another (hypothetical) transaction for it.<sup>126</sup> Its rationale is that

“[r]estructuring of legitimate business transactions would be a wholly arbitrary exercise, the inequity of which could be compounded by double taxation where the other tax administration does not share the same views as to how the transaction should be structured”.<sup>127</sup>

Leaving aside permissible recharacterisations based on domestic anti-abuse rules,<sup>128</sup> the OECD—despite rejection from domestic courts<sup>129</sup> and criticism in scholarship<sup>130</sup>—explicitly addresses transactional or structural adjustments that recognise the existence but not the form of a transaction: first, the OECD MC Commentary accepts that the recharacterisation of a loan into equity by means of a thin capitalisation rule falls squarely within the scope of Article 9 of the OECD MC.<sup>131</sup> Secondly, paragraphs 1.65 and 1.66 of the 2010 OECD TPG deal with structural adjustments relating to the totality of the terms of a structure or transaction,<sup>132</sup> although such structural adjustments are restricted to “exceptional circumstances” (that is, “restricted structural adjustments”).<sup>133</sup> The application of these restricted structural adjustments in the area of business restructurings is furthermore explored in some detail in Chapter IX of the OECD TPG.<sup>134</sup>

The OECD TPG<sup>135</sup> currently provide detailed guidance on the relevance of the actual transactions undertaken by associated enterprises and the exceptional—that is, “rare” or “unusual”<sup>136</sup>—circumstances in which it may be legitimate and appropriate for a tax administration not to recognise, for transfer pricing purposes, a transaction that is presented by a taxpayer, such

<sup>126</sup> Bullen, above fn.71, 137.

<sup>127</sup> OECD TPG, above fn.1, para.1.64; for a discussion of these rationales see Bullen, above fn.71, 232–273.

<sup>128</sup> OECD TPG, above fn.1, para.9.162 refers to the general discussion of the relationship between domestic anti-abuse rules and treaties in Nos 9.5, 22 and 22.1 OECD MC, above fn.4, Comm. on Art.1; see also 2008 OECD Discussion Draft on Business Restructuring para.195; cf. Wittendorff, above fn.72, 107, 118; Wittendorff, above fn.11, 152 and 154; Liaugminaite, above fn.123, 107, 110, and following; Bullen, above fn.71, 171–179. However, Art.9 arguably bars the re-characterisation of transactions based on domestic anti-abuse rules that apply standard conditions without regard to whether a transaction lacks substance; see Wittendorff, above fn.72, 107, 118–119; Wittendorff, above fn.11, 161.

<sup>129</sup> Bullen, above fn.71, 732 with note 3089.

<sup>130</sup> The proposition that Art.9(1) applies to adjustments other than pricing transactions is widely rejected in scholarship; see, e.g. Wittendorff, above fn.72, 107, 115–119; J. Wittendorff, above fn.11, 152–154 and also, e.g. 332, 396–397.

<sup>131</sup> OECD MC, above fn.4, Comm Art.9 No.3(b) and (c).

<sup>132</sup> See also OECD TPG, above fn.1, paras 9.161 and following and 2008 OECD Discussion Draft on Business Restructuring paras 201–205; see also Wittendorff, above fn.72, 107, 122–129; M. Erasmus-Koen, “Art. 9 of the OECD Model Convention” in A. Bakker (ed.), *Transfer Pricing and Business Restructurings* (2009), 99, 106–117; Wittendorff, above fn.11, 172; Liaugminaite, above fn.124, 107, 121–122.

<sup>133</sup> OECD TPG, above fn.1, para.1.65.

<sup>134</sup> OECD TPG, above fn.1, paras 9.168–9.187.

<sup>135</sup> OECD TPG, above fn.1, paras 1.64–1.69 (non-recognition adjustments in exceptional circumstances); see also paras. 9.34–9.38 (explanation of the difference between making a comparability and a non-recognition adjustment and discussion of the relationship between the guidance at para.1.49 and paras 1.64–1.69) and paras 9.161 and following (concerning recognition of the actual transactions undertaken in the context of business reorganisations).

<sup>136</sup> OECD TPG, above fn.1, para.9.168.

as risk assignments<sup>137</sup> or the terms of a CCA.<sup>138</sup> Such non-recognition of the parties' characterisation or structuring of a transaction or arrangement may be appropriate in two particular circumstances<sup>139</sup>: first, if the economic substance of the transaction or arrangement differs from its form (for example, recharacterisation of debt investments as a subscription of capital in accordance with its economic substance).<sup>140</sup> Secondly, while the form and substance of the transaction are the same, if the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner (the "commercial rationality test")<sup>141</sup> and the actual structure impedes, from a practical perspective, the tax administration's ability to determine an appropriate transfer price (the "practical impediment test")<sup>142</sup>; the OECD TPG mention, as an extreme example, the recharacterisation of a long-term, lump-sum sale contract granting to the buyer unlimited entitlement to intellectual property rights arising from future research conducted by the seller as a continuing research agreement between the buyer and seller.<sup>143</sup>

In each of these situations, the parties' characterisation or structuring of the transaction or arrangement (that is, the totality of its terms) is regarded as the result of a condition that would not have existed between independent enterprises<sup>144</sup>; Article 9 of the OECD MC would thus

"allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties transacting at arm's length".<sup>145</sup>

In restructuring, tax administrations have to determine the underlying reality behind a contractual arrangement<sup>146</sup> and may additionally refer to an uncontrolled alternative characterisation or structure that comports as closely as possible with the actual facts of the case (for example, the closing down of a factory, an actual transfer of property)<sup>147</sup> to determine an appropriate

<sup>137</sup> OECD TPG, above fn.1, para.1.69; see also OECD TPG, above fn.1, paras 1.49, 9.34–9.38 and 9.165–9.166 (also discussing the difference between making a comparability adjustment and not recognising the risk allocation in the controlled transaction); cf. OECD, *The Taxation of Global Trading of Financial Instruments* (1998), para.123, assuming that restructuring of risk allocation is indeed only feasible under the "exceptional circumstances" of (then) the 1995 OECD TPG paras 1.36–1.37 (now OECD TPG, above fn.1, paras 1.64–1.65); for an extensive discussion see Bullen, above fn.71, 198, 199–202, 482–507.

<sup>138</sup> OECD TPG, above fn.1, paras 8.29–8.30; Bullen, above fn.71, 183, 199.

<sup>139</sup> OECD TPG, above fn.1, para.1.65; for an extensive analysis see Bullen, above fn.71.

<sup>140</sup> OECD TPG, above fn.1, paras 1.65 and 9.170; see also Australian Taxation Ruling 97/20 of November 5, 1997 para.2.72; the Canadian Circular 87-2R of September 27, 1999 paras 43–45; US Treas. Reg. § 1.482–1(f)(2)(ii) (stating that the tax administration "will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance"); see also Bullen, above fn.71, 433–459.

<sup>141</sup> For a discussion of this test see OECD TPG, above fn.1, paras 9.171–9.179; see also 2008 OECD Discussion Draft on Business Restructuring (2008), paras 207–213; cf. Bullen, above fn.71, 511–574.

<sup>142</sup> Bullen, above fn.71, 564–574.

<sup>143</sup> OECD TPG, above fn.1, paras 1.65 and 9.170; see also, e.g. the Canadian Circular 87-2R of September 27, 1999 paras 150–151; the Netherlands Decree IFZ2001/295M of March 20, 2001 para.5 (English translation published in (2001) 8 ITPJ 184, and (2004) 13 Tax Mgmt Trans. Pricing Rep. 494), referring to Dutch Supreme Court of August 17, 1998, no. 32.997, *BNB* 1998/385.

<sup>144</sup> OECD TPG, above fn.1, para.1.66.

<sup>145</sup> OECD TPG, above fn.1, para.1.66; for the consequences of a structural adjustment see Bullen, above fn.71, 423–430.

<sup>146</sup> OECD TPG, above fn.1, paras 1.67 and 9.185.

<sup>147</sup> OECD TPG, above fn.1, para.9.187.

substitute for the non-recognised transaction.<sup>148</sup> However, non-recognition may only take place in exceptional cases<sup>149</sup> and is excluded if the controlled structure can indeed be identified between unrelated enterprises.<sup>150</sup> In that regard, the “commercial rationality test” must be applied with “great caution” to prevent unnecessary interference with the business decisions of a taxpayer.<sup>151</sup> Particularly, the fact that a related-party arrangement is unlike those found between independent parties (that is, it is a unique transaction or transaction structure) does not mean, in and of itself, that the chosen arrangement was not made at arm’s length.<sup>152</sup> Moreover, a structural adjustment is certainly not warranted merely because an alternative structure triggering a higher tax burden could have been adopted or because the choice of transaction is tax motivated.<sup>153</sup>

## Summary

Supported by political leaders, the OECD’s Action Plan identifies a number of “pressure areas” of BEPS, including actions in the area of transfer pricing with regard to intangibles, the allocation of risk and capital and other high-risk transactions. All of these actions are intended to assure that transfer pricing outcomes are in line with value creation or—phrased differently—to “align taxation and substance”. In doing so, the OECD addresses the key areas of income shifting and creation of “stateless income”, but also touches upon the ongoing discussion about the amount of value creation in source countries. However, neither the BEPS Report nor the Action Plan reveals preconceptions as to the precise nature of the changes that may be required to address these issues. The course of action is not to facilitate conceptual changes and to renounce the arm’s length principle, but rather

“to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalisation”.<sup>154</sup>

As such measures may be “either within or beyond the arm’s length principle”,<sup>155</sup> changes to Article 9 of the OECD MC may be a possible route of action, with such changes probably being accompanied by a multilateral instrument mentioned in Action 15 to facilitate a swift revision of the more than 3,000 existing bilateral double taxation conventions.

In any event, the OECD’s suggested actions in the transfer pricing area will certainly spur the ongoing debate on whether some form of formulary apportionment could nevertheless be the ultimate solution to BEPS through transfer pricing. Moreover, alternative routes to policy solutions may receive additional attention. For example, it has been suggested that an extension or strengthening of CFC rules, which is addressed as Action 3 in the OECD’s Action Plan, might take pressure off transfer pricing as it would make the residence countries of group parents

<sup>148</sup> OECD TPG, above fn.1, paras 1.68 and 9.186–9.187.

<sup>149</sup> OECD TPG, above fn.1, para.9.168.

<sup>150</sup> OECD TPG, above fn.1, para.9.172; see also Bullen, above fn.71, 392 and 493–494.

<sup>151</sup> OECD TPG, above fn.1, paras 9.171 and following.

<sup>152</sup> 2008 OECD Discussion Draft on Business Restructuring para.27; see also Bullen, above fn.71, 403–422, also with a discussion of a hypothetical arm’s length test to be applied.

<sup>153</sup> OECD TPG, above fn.1, para.9.181; Bullen, above fn.71, 391.

<sup>154</sup> Action Plan, above fn.29, 20.

<sup>155</sup> Action Plan, above fn.29, 20.

largely indifferent about income shifting in the group; conversely, such rules would also reduce the incentives of MNEs to shift income out of source countries<sup>156</sup>.<sup>157</sup>

<sup>156</sup> See for this debate K.A. Bell and B.W. Reynolds, “New CFC Rules May Provide Better Solution to BEPS Than Transfer Pricing Overhaul, U.S. Official Suggests” (2013) 21 Tax Mgmt Trans. Pricing Rep. 1127, and following.

<sup>157</sup> Arm’s length transactions; OECD; Transfer pricing; Risk