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Stanley I. Langbein

Max R. Fuss

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STANLEY I. LANGBEIN* & MAX R. FUSS**

The rules and concepts which govern "international taxation" among the major trading nations derive from work in the 1920s by the League of Nations.[1] The principles first enunciated there are widely seen as having generated a remarkably durable and stable regime, lasting nearly a century to the present day.[2] In the first half of this second decade of the twenty-first

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* Professor of Law, University of Miami School of Law.
** Doctoral candidate (Ph.D. equivalent) at the Institute for Tax Law, University of Cologne, Germany; visiting research scholar at the University of Miami School of Law, 2016-17 academic year.
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1. The major documents in this initiative are collected in 4 STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, LEGISLATIVE HISTORY OF UNITED STATES TAX CONVENTIONS 3997, 4151–94 (1962) [hereinafter Conventions Legislative History]. For early literature describing or discussing this work, *see* H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 COLUM. J. TRANSNAT'L L. 359 (1981) (*See* Part II for discussion of the work of the League in the 1920s and 1930s); Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625 (1986); *see also* Michael J. Graetz & Michael M. O'Hear, *The 'Original Intent' of U.S. International Taxation*, 46 DUKE L. J. 1021, 1022–28 (1997).

At the current time the rules and concepts that undergird such international "system" as exists are embodied in "model conventions" of international organisations, principally that of the Organisation for Economic Co-operation and Development (OECD), an organisation comprising of mostly developed countries and headquartered in Paris. Org. for Econ. Co-operation and Dev. [OECD], *Model Tax Convention on Income and Capital* (2014) [hereinafter OECD Model Convention]. That Model is largely designed for use between two developed countries. There is also a model convention designed by the United Nations for use between one developed country and one developing country. U.N. DEP'T OF ECON. & SOC. AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES (2011) [hereinafter UN Model Convention].

These Model Conventions are advisory only, although they are quite influential. What actually governs the taxation of transnational enterprises (TNEs), as of all taxpayers, are bilateral conventions executed between the nations of the world. In all but unusual cases, these conventions include clauses that closely follow, if indeed they do not literally incorporate, the provisions set forth in the Models.

2. *See, e.g.*, Victor Zonana, *International Tax Policy in the New Millennium: Developing an Agenda*, 26 BROOKL. J. INT'L L. 1253, 1255 (2001) (system a "flawed miracle"); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301

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century, the major economic powers of the world undertook an initiative widely seen as aimed at, or having the potential to, substantially revise this existing but aging regime.[3] The initiative was called the Base Erosion and Profit Shifting project, or, by its acronym, BEPS.[4]

Undoubtedly the most significant single facet of the historic regime are the rules governing "transfer pricing," which allocate the tax base generated by the profits of transnational enterprises (TNEs) among the national jurisdictions within which those enterprises operate.[5] And despite the stability of the overall system, the "transfer pricing" rules have always proved neither durable nor satisfactory. The rules operate under the so-called "arm's length" principle—the idea that allocation of profits among countries should be accomplished by treating the TNEs as if the enterprises in different jurisdictions were separate enterprises engaged in transactions at prices that would be charged between independent enterprises.[6] However, this standard, though constant over decades, has undergone three formative or transformative changes in eighty years.[7] The first was when it emerged in the 1930s;[8] the second, when the United States issued the first detailed interpretation of the standard in the 1960s;[9] and the third, finalized in the 1990s, when the regime of the 1960s encountered difficulties and engendered controversy in the late 1980s and early 1990s.[10]

However, the regime of the 1990s, at least by about 2010, had proved at least as problematical as its predecessors. Central to its difficulties was a practice among TNEs, which became widespread in the early twentieth century, of concentrating "functions" risk and asset ownership, which under the 1990s rules underlie the right of jurisdictions to tax corporate profits, in subsidiaries organized in low-tax jurisdictions (or "tax havens"), resulting in

(1996); H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the "International Tax System"*, 53 TAX L. REV. 137 (2000).

3. *See infra* Part I.A and note 17. The initiative was undertaken by the Group of 20 ("G20"), the membership, but the technical work was assigned to and borne by the OECD, all as discussed therein.

4. Itai Grinberg, *The New International Tax Diplomacy*, 104 GEO. L. J. 1137, 1138 (2016).

5. Article 9 of both Model Conventions referred to in note 1 concerns the allocation among the state signatories to a convention of the profits of an integrated group of companies operating in both jurisdictions, the "transfer pricing" problem. The application of Article 9 is the subject of comprehensive "Guidelines" which are an important element of the extant international system. OECD, *Transfer Pricing Guidelines for Multinational Enterprises* (2014) [hereinafter 2010 OECD Guidelines]. As in the case of the models themselves, these Guidelines are subject to a separate set of principles as applied to a convention between a developed and a developing country, promulgated by the UN. U.N. DEP'T OF ECON. & SOC. AFFAIRS, U.N. PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES (2013) [hereinafter cited as UN Transfer Pricing Manual].

6. This standard is mandated by Article of both the UN and OECD Model Conventions.

7. *See infra* notes 8-10.

8. *See infra* Part II-C.

9. *See infra* Part III-A and III-B.

10. *See infra* Part IV.

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the disproportionate allocation of taxable profits to those low-tax countries.[11] The income so protected from major-country taxation came to be called "stateless" income.[12] And this core problem of the existing international system lay at the heart of the decision by the major economic powers to undertake the BEPS initiative—and accordingly lies at the core of the BEPS initiative itself. Thus, just as transfer pricing is the most significant facet of the historic overall system, it is also the key element of the contemporary BEPS initiative.[13]

The BEPS initiative was undertaken through fifteen so-called "Action items" (or "Actions"), four of which directly involve "transfer pricing."[14] The Actions were effected largely through "final reports" which were finalized for the most part during 2015,[15] and which were based on various "discussion drafts" and preliminary "deliverables" issued for the most part in 2014.[16] The final reports under Actions 8 through 10 have stirred both confusion and controversy in the United States and elsewhere.

The principal point of both confusion and controversy in the transfer pricing reports concern the relationship of their key concept—"value

11. Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 722–724 (2011).

12. The phrase was coined in two articles by Professor Edward Kleinbard, which articles are among the most useful descriptions of the legal basis of the process. *See* Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011); Edward D. Kleinbard, *Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011).

13. The authors are in general agreement with the position of Professor Richard Vann that "transfer pricing is the dominant international issue as compared to" the congeries of other issues addressed by the Model Conventions. Richard J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 WORLD TAX J. 291 (2010) [hereinafter *Vann Hard-Boiled WonderWorld*].

14. *See infra* app. at 349–50. These are Actions 8 through 10 and 13. As many as six of the other Actions involved areas not strictly part of transfer pricing, but which significantly overlap it. These include Action 1 (addresses the challenges of the digital economy); Action 4 (limits base erosion via interest deductions and other financial payments), Action 5 (counters harmful tax practices more effectively, taking into account transparency and substance), Action 7 (prevents the artificial avoidance of PE status); Action 11 (establishes methodologies to collect and analyze data on BEPS and the actions taken to address it), and Action 14 (makes dispute resolution mechanisms more effective).

15. The Final Reports governing Actions 8 through 10 are set forth in OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10 - 2015 Final Reports*, (2015) [hereinafter Final Actions 8–10 Reports]. Those governing Action 13 are set forth at OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report*, (2015) [hereinafter Final Action 13 Report]. *See infra* Part V.B. The Final Actions 8–10 Reports is discussed in detail at Part V.B. We sometimes use the singular because, although the documents are styled "Final Reports," and discuss matters that were discussed separately in seven separate preliminary deliverables or discussions drafts, it was issued as a single document. The Final Reports are for the most part set forth as amendments to what had been the 2010 OECD Transfer Pricing Guidelines, which with the amendments were reissued as the 2017 Guidelines.

16. *See infra* Part V.B. (discussing the relevant preliminary deliverables and discussion drafts).

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creation"[17]—to the practice of creating "central" subsidiaries, and the impact of that concept on a key element of the regime adopted in the 1990s, that of generally respecting "contractual allocations" made by the TNEs themselves. The BEPS Final Reports plainly represent a tense compromise between two views, one of which would have largely preserved the 1990s regime, with its emphasis on contractual allocations and asset ownership, and its broad tolerance of the inability of the arm's-length standard to solve the "central-party"/stateless income practice, on the one hand; and the other of which would have gone farther in overriding taxpayer-devised allocations and establishing international norms determining where value is created. This compromise results in rules that are both highly complex and frequently ambiguous, and most observers regard the rules devised as in all likelihood unstable and in need of further work and refinement.

The controversy about the final rules concerns their consistency with the norms of the international systems inherited from the 1920s. Some believe the BEPS reports and the "value creation" paradigm represent a departure from those norms, and are, therefore, to some extent either objectionable or impermissible. These observers generally see honoring "contractual allocations" as an essential aspect of the "arm's length" principle, and tend to view that principle as exhaustively defining international norms for allocating taxing rights. Some others do not necessarily deny that the "value creation" paradigm represents some departure from pre-existing norms, including particularly the "arm's length" principle, but advocate such a departure as a desirable development in light of emerging patterns of international economic activity.

This paper advocates a middle view, which sees the "value creation" paradigm not as a departure from international norms but as a useful, if not profound, elaboration of it. In our view, the fundamental principle of the international system is that the right to tax income is allocated in the first instance to the state to which that income bears the greatest degree of "economic allegiance." We perceive the "arm's length" principle not as an end in itself, or an exhaustive definition of how taxing rights should be allocated, but rather as a subordinate principle implementing the supervening idea of economic allegiance. We believe the historical record supports this view. In this light, we see the value creation paradigm as effectuating, and indeed, paralleling the "economic allegiance" idea. Insofar as the central party/stateless income result is concerned, we believe such

17. Final Actions 8–10 Reports, *supra* note 15, at 9. The term "value creation" was first set forth in Action 8, which refers to the income from *intangible property* as being allocated in accordance with "value creation." Despite this initial limitation, the Final Actions 8–10 Reports established "value creation" as the overarching objective of the transfer pricing items of the project as a whole. *See infra* Part III.C and Part IV.A. However, even in literal terms, this did not differ substantially from the terms and implications of Action 8 because it is widely conceded that income from intangible property presents the greatest area of difficulty in transfer pricing, indeed even some tendency, which we regard as fallacious, to equate all "residual" income, which is not facilely allocable, to income from intangible property.

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results reveal that the underlying complex of rules that permit it, including contractual allocations, "developer/assister" rules, deviate from the general principle of "economic allegiance," if not indeed as well from the subordinate "arm's length" principle.

The primary purpose of this paper is to explain this middle view, and to document the basis for seeing what we call the "value creation" paradigm as continuous with, rather than at odds with, the system which originated a near century ago and which prevails today. Interwoven with, and indeed essential to, this position is a view of the third incarnation of the "arm's length" system introduced in the early 1990s as considerably *less* consistent not only with the principle of "economic allegiance" but with the (what we deem as) subsidiary "arm's length" principle itself. We, thus, detail grounds for holding it was on account of this circumstance that the system fostered the phenomena of "central" parties/developers and "stateless income." A secondary but important purpose of the paper is to document the content of the "value creation" paradigm as that paradigm emerged in the work of the Organisation for Economic Co-operation and Development (OECD) in the period between the completion of work on the 1990s system (1995) and the institution of the BEPS initiative (2013); as that work informed the BEPS process; and as the paradigm is implemented in BEPS final reports themselves. Emphasis is placed on how the "value creation" paradigm throughout its evolution and in the BEPS reports, addresses the problems of "central" or "developer" subsidiaries, and on how defences of the 1990s system and its conceptions of "contractual allocations" and intangibles "ownership" influenced the BEPS process, and ultimately limited the degree of innovation effected by the BEPS Final Reports.

Much of the work of the OECD in the 1995–2013 remains unfamiliar to United States tax practitioners, and indeed, to a considerable extent to the academic tax community in the United States. A tertiary purpose of the paper is to enhance the familiarity of these communities with these matters, to elevate the ongoing dialogue, and to debate with the BEPS transfer pricing principles that are certain to generate. Also, even if the United States remains slow to incorporate those principles into its own transfer pricing rules, United States practitioners will need enhanced familiarity with the rules as other countries take seriously and incorporate those principles into their own enforcement practices as they affect United States-based TNEs and other taxpayers.

This article proceeds in six parts. The emphasis of the earlier parts is on demonstrating that the emergent "value creation" idea has ancient roots and is consonant with long accepted ideals. The emphasis of the later parts is on demonstrating the deviation of the pre-BEPS transfer pricing ideas from those ideals, and on showing how those rules gave rise to the "stateless income" abuses. As well, the Article emphasizes on elaborating the manner in which the "value creation" ideal, both in its nascent form in the pre-BEPS work of the OECD, and its more mature form in the BEPS Reports, and

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how to deal with the difficulties of the immediate predecessor system and of the "central party" problem that system spawned.

Part I describes the emergence of the BEPS project and the value creation paradigm. It describes first (I-A) the changing roles of international institutions in with respect to tax policy in the wake of the 2007–08 global financial crisis, particularly the advent of the active participation by the Group of 20 ("G20") in formulating international policy.[18] The G20 enjoys participation by a far greater diversity of nations than did institutions which previously dominated international policy, like the Group of Seven and the OECD, and this predictably influences substantive policy. Part I-B describes what we call the dual "negative" aspect of the "value creation" idea: on the one hand, to combat "profit shifting" which concentrated the cross-border tax "base" of TNE taxpayers in low-tax jurisdiction; but on the other, to avoid resorting to "formula apportionment," an allocation method which it is thought would require a change in the terms of the Model Convention, and thus, a cumbersome process of amendment to the network of bilateral tax conventions which actually govern taxation in the various nations of the world.[19]

Parts II through IV trace the historical development of transfer pricing concepts, with the objectives of demonstrating (1) that there are governing theoretical principles of the international system which are consistent over a long period of time; and (2) that the value creation paradigm is not only consistent with those principles, but implicit in them in each and every phase of their development. The three parts correspond to the three formative/transformative epochs of the "arm's length" standard.[20] Part II surveys the origin of the international system, and demonstrates that its overarching goal was the allocation of tax base according to the "economic allegiance" of the tax base involved (Part II-A).[21] We show, in substantial part based on some sources which have been obscured over time, that the "value creation" idea is a key aspect of those governing conceptions, as they relate to the taxation of business income at source (Part II-B).[22] We show further that the idea of value creation is fully consistent with if not integral to the work which is the origin of the "arm's length" standard (Part II-C-1),[23] as well as the final synthesis of the work of the League of Nations, the Model Conventions accepted at the end of World War II (Part II-C-2).[24]

Part III concerns the relation of the value creation paradigm to the changes in the conception of the "arm's length" principle during the second epoch, the regime of the United States regulations finalized in 1968 (Part

18. *See infra* Part I.A.
19. *See infra* Part I.B.
20. *See supra* notes 8-10 and accompanying text.
21. *See infra* Part II.A.
22. *See infra* Part II.B.
23. *See infra* Part II.C.1.
24. *See infra* Part II.C.2.

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III-A),[25] as well as the original OECD guidelines issued in 1979 (Part III-B).[26] Part III-B details how the 1979 Guidelines reflect the beginning of a confusion about the "arm's length" standard, treating the standard as determinative of what constitutes a proper allocation, rather than a principle that aids a larger and precedent idea about allocation.[27] Part III-C describes the crisis of the United States regulations encountered in the mid-1980s and the in the wake of the historic Tax Reform Act of 1986, including the issuance of the White Paper mandated by the legislative history of the 1986 Act (Part III-C-1); the series of proposed and temporary regulations which led to amendment of the United States regulation (Part III-C-2), and the final United States regulations (Part III-C-3).[28] Part III-C-3 shows the manner in which the final United States regulations laid the groundwork for the profit shifting problem of central parties, "developers/assisters," and stateless income.[29] Part III-D describes the synthesis of work of the 1985–95 period, the period of the "transfer pricing wars" in the 1995 revision of the OECD Guidelines.[30] This Part shows that even during the period of the formulation of the United States regulations, and in the 1995 Guidelines as well, there were fissures developing between the United States and OECD approaches (Part III-D-1), divisions which were in contrast to the original situation under the 1968 regulations, the terms of which the OECD had followed quite closely.[31] Part III-D-2 shows the extent to which the 1995 Guidelines still reflected, though they at times distorted, a governing ideal that congruent with the BEPS concept of value creation.[32]

Part IV concerns the evolution of OECD thought during the regime of the 1995 regulations, with an emphasis upon the OECD's growing concerns with—an inclination to depart from—aspects of those regulations which create tension with the ideal of value creation. The evolution takes place in three sets of studies.[33] The first, discussed in Part IV-A, involved the OECD's formulation of principles to govern allocations under Article 7 of the Model Conventions, which concern profits allocations among (not separately incorporated) branches of a multijurisdictional enterprise, where the OECD declined to permit any form of taxpayer-determined "starting point" like that authorized for inter-corporate "contractual allocations" by the 1995 Guidelines.[34] This became the "authorized OECD approach" (AOA) to allocations among permanent establishments.[35] The second, discussed in Part IV-B, was the OECD's study of "restructuring"

25. *See infra* Part III.A.
26. *See infra* Part III.B.
27. *Id.*
28. *See infra* Part III.C.1–3.
29. *See infra* Part III.C.3.
30. *See infra* Part III.D.
31. *See infra* Part III.D.1.
32. *See infra* Part III.D.2.
33. *See infra* Part IV.
34. *See infra* Part IV.A.
35. 2010 OECD Guidelines, *supra* note 5, at 237.

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income taxation" in general and the "separate accounting approach" in particular. *Firstly*, the Report argues that "[i]n economic fact, no profit accrues to the enterprise consisting of the producing corporation and the selling corporation, until the goods have been sold by the selling corporation to outsiders,"[181] but that "economic fact must inevitably give way to the definite principles and provisions of law under which business is conducted."[182] *Secondly*, with regard to the income allocation to subsidiaries, a question Carroll treated as generally to be handled in the same way as income allocation to permanent establishments but taking their specific differences into account, the Report assumes that the "fundamental legal difference" between the two is that subsidiaries *can enter into legally binding contracts with other "component parts."*[183]

On this basis, the Report airily concludes that

> As the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments of an enterprise but treated as independent legal entities; and if it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise.[184]

The allocation regime Carroll, thus, seemingly infers from the possibility of concluding legally binding contracts that the functions the entities perform are separable enough to reliably price them completely independently by using market comparables. In other words, contracts to Carroll seem to have been more of an expression of separable functions than the contract in and by itself being the actual reason to analyze and price the functions separately. Additionally, that no comparables could be found for such separated functions was a scenario Carroll assumed did and would rarely occur.[185]

As to (iv). Therefore, evidently, less clear was the solution to the allocation problem especially when (i) no comparables could be found *in the subsidiary case*, and (ii) *in the PE case*, functions were heavily intertwined with the effect that "the income of an establishment becomes dependent upon the outcome of its relations with other establishments or subsidiaries of the enterprise."[186] This is a situation we today call integrated value-chains, or as the Carroll Reports describe it, interactions between "*establishments which create, add value to, or sell a product, the profit or loss of each of which awaits the*

181. *Id.* at 176.
182. *Id.* at 177.
183. *Id.* at 176.
184. *Id.* at 177.
185. *See id.* at 191 (in context of profit allocations to PEs).
186. *Id.* at 178.

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the English-speaking world. We recognize that the result is an inordinately long piece, covering an extensive but turgid range of material, with conclusions susceptible to challenge in light of developments likely to occur within a short time. It is hoped, however, that this will illumine the current state of affairs and provide a basis for some consensus on a path forward. It should be clear that this essay is only a beginning and a platform for further research. The focus of such research should be, of course, on clarifying and hardening the value creation paradigm, mostly by developing concrete and acceptable grounds for identifying the locus of "value creation" in a wide range of business circumstances.

I. The OECD/G20 BEPS-Project: "Value Creation" Enters the International Tax Nomenclature

A. Setting the Agenda: Institutional Changes and the Development of the Substantive Tax Policy Goals at the G20 Leaders Level

Prior to the 2007–08 "global financial crisis," an informal group of the largest Free World economies met periodically as a forum for the discussion and management of global economic and financial issues, primarily the maintenance of international financial stability. The group, initially the Group of Seven (G7), convened for the first time in 1975, following the abrogation of the Bretton Woods Agreement by the United States in 1971 and 1973, and institution of a regime of floating exchange rates worldwide.[38] Initially it comprised six nations (France, Germany, Italy, Japan, the United Kingdom, and the United States); in 1976, the group added Canada.[39] These Group of Seven nations today account for about 14 percent of the world's population, and about 60 percent of its accumulated wealth and aggregate gross domestic product.[40] In 1997, the group expanded to include Russia, which was expelled in 2014 in connection with economic sanctions imposed in the wake of the annexation of neighboring Crimea.[41]

During the "global financial crisis" of 2007–08, the role and ascendancy of the Group of Seven waned. In the late 1990s, principally under the auspices of two of the G7 members, Germany and the United States, a larger group had been formed for the discussion of financial stability issues. After a couple groups were briefly formed in 1997 and 1998, a Group of 20 was

38. *The History of the G7*, G7 Germany, https://www.g7germany.de/Content/EN/StatischeSeiten/G7_elmau_en/texte_en/2014-11-05-geschichte-g8.html (last visited Oct. 28, 2017).
39. *Id.*
40. Daniel O'Donnell, *G7 in Figures*, Federal Statistical Office of Germany (Statistisches Bundesamt) (May 2015), https://www.destatis.de/EN/Publications/Specialized/InternationalData/G7InFigures0000155159004.pdf?__blob=publicationFile.; Michael Wilson, *G7 this, G7 that. . . but what is the G7?* Global Citizen (May 22, 2015), https://www.globalcitizen.org/en/content/g7-this-g7-that-but-what-is-the-g7/.
41. The expulsion was at the time expected to be temporary, but it has not been reversed in the time since.

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formed, comprising the G-8 members, and twelve others, most of them so-called "emerging" nations.[42] Until 2008, meetings of the G20 were only at the finance minister or central bank governor level, but in November 2008, the Group of 20 held its first "Leaders' summit"—meeting of the heads of state or government—in Washington, D.C.[43] In September 2009, the Group of 20 at its third summit in Pittsburgh, Pennsylvania, announced that thenceforth the Group of 20 would constitute the "premier forum" for "international cooperation" among its twenty nations.[44] The G20 nations comprise about 60 percent of the world's population, and about 85 percent of its aggregate gross domestic product.

At the initial G20 summit in Washington, D.C. in November 2008, at the very apex of the financial crisis, the Leaders of the G20 convened determined to enhance cooperation to reestablish the stability of and to institutionalize procedures to reform the global financial system.[45] By the

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42. *See* G8 Gleneagles Summit, *Joint Declaration of the Heads of State and/or Government of Brazil, China, India, Mexico and South Africa participating in the G8 Gleneagles Summit*, (July 7, 2005) http://www.combusto.net/includes/Joint_Declaration.pdf.
Five of these countries began partly participating in Group of Eight deliberations as a "Group of Five" in 2005. These included three of the four nations which later came to be termed the "BRIC" countries—Brazil, India, China (the fourth, Russia, was already a member of the Group of Eight)—and Mexico and South Africa. The Group of 20 as formed in 1999 added six other countries, Argentina, Indonesia, Saudi Arabia, Turkey, South Korea, and Australia. The European Union as a unit was the twentieth member.

43. *See* G20 Summit on Financial Markets and the World Economy, Washington, D.C., U.S., Nov. 15, 2008, *Declaration of the Summit on Financial Markets and the World Economy*, (Nov. 15, 2008).

44. G20 Pittsburgh Summit 2009, Pittsburgh, Pa., U.S., Sept. 24–25, 2009, *Leaders Statement: The Pittsburgh Summit*, ¶ 19, at 3 (Sept. 25, 2009) [hereinafter G20 Pittsburgh Summit, Leaders Statement].

45. *See* G20 Summit on Financial Markets and the World Economy, Washington, D.C., U.S., Nov. 15, 2008, *Declaration of the Summit on Financial Markets and the World Economy*, ¶ 1 (Nov. 15, 2008). Further, the Leaders agreed to "[p]romoting Integrity in Financial Markets: We commit to protect the integrity of the world's financial markets by bolstering investor and consumer protection, avoiding conflicts of interest, preventing illegal market manipulation, fraudulent activities and abuse, and protecting against illicit finance risks arising from non-cooperative jurisdictions. We will also promote information sharing, including with respect to jurisdictions that have yet to commit to international standards with respect to bank secrecy and transparency." As "[m]edium-term actions" the Leaders envisioned that:

- "National and regional authorities should implement national and international measures that protect the global financial system from *uncooperative and non-transparent jurisdictions* that pose risks of illicit financial activity."
- "The Financial Action Task Force should continue its important work against money laundering and terrorist financing, and we support the efforts of the World Bank - UN Stolen Asset Recovery (StAR) Initiative."
- "Tax authorities, drawing upon the work of relevant bodies such as the Organisation for Economic Cooperation and Development (OECD), should *continue efforts to promote tax information exchange. Lack of transparency and a failure to exchange tax information should be vigorously addressed.*"

Id. at 3, 8. (Action Plan to Implement Principles for Reform, Promoting Integrity in Financial Markets) (emphasis added).

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time of the second Leaders' summit in April 2009 in London, the crisis had resulted in losses in stock market values of some estimated U.S. $4 trillion,[46] had spread into the real economy and affected public treasuries.[47] A global recession ensued, and a Euro currency crisis had begun, which had made necessary the institution of a European Financial Stability Facility.[48] That Facility had to bail-out several states, among them was Ireland.[49] Hence, in London, the Leaders of the G20 perceived "the greatest challenge to the world economy in modern times."[50] To them, an important part of the "global solution"[51] was "strengthening financial supervision and regulation"[52] which entailed "tak[ing] action against non-cooperative jurisdictions, including tax havens."[53] In a concurrent Declaration, the G20 Leaders specified their determination to "protect public finances . . . against the risks posed by non-cooperative jurisdictions."[54] To this end, they considered and identified a possible "toolbox of effective counter measures"[55] against jurisdictions that do not adhere to "the international standards in the . . . tax area"[56] that contained measures such as:

- increased disclosure requirements on the part of taxpayers and financial institutions to report transactions involving non-cooperative jurisdictions;
- withholding taxes in respect of a wide variety of payments;
- denying deductions in respect of expense payments to payees resident in a non-cooperative jurisdiction;
- reviewing tax treaty policy;

46. *See* International Monetary Fund [IMF], *Responding to the Financial Crisis and Measuring Systemic Risks*, ch. 1 (Apr. 2009) (on Stabilizing the Global Financial System and Mitigating Spillover Risks).

47. *See, e.g.*, OECD, *Fiscal Consolidation: Targets, Plans, and Measures*, 11 OECD J. ON BUDGETING 16 (2011), finding "government's fiscal deficits soared due to stimulus measures" and overall a "dire fiscal situation" that has led to "fiscal solvency concerns" manifested in "interest rate hikes on sovereign bonds and downgrading by rating agencies." *See also Offshore Profit Shifting and the U.S. Tax Code: Hearing Before the Permanent Subcommittee on Investigations of the S. Comm. on Homeland Sec. & Gov't Affairs*, 112th Cong. 1–8 (2012) (statement of Sen. Carl Levin, S. Comm. On Homeland Sec. & Gov't Affairs).

48. *History*, EUROPEAN STABILITY MECHANISM, https://www.esm.europa.eu/about-us/history (last visited Oct. 28, 2017).

49. The bail-out of Ireland might be particularly important to the dynamic within European Finance Ministries since typical tax reduction structures for the European market use incentives the Irish tax law offers; the state-aid cases against Ireland pursued by the EU-Commission still seem to echo these commotions.

50. G20 London Summit 2009, Apr. 2, 2009, *The Global Plan for Recovery and Reform*, ¶ 2, at 1 (Apr. 2, 2009) [hereinafter G20 London Summit, Leaders' Statement].

51. *Id.*

52. *Id.* ¶ 4 and fn 13.

53. *Id.* ¶ 15, point 7.

54. G20 London Summit 2009, Apr. 2, 2009, *Declaration on Strengthening the Financial System*, at 4 (Apr. 2, 2009) [hereinafter G20 London Summit, Declaration on Strengthening the Financial System].

55. *Id.*

56. *Id.*

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- asking international institutions and regional development banks to review their investment policies; and,
- giving extra weight to the principles of tax transparency and information exchange when designing bilateral aid programs.[57]

As an immediate response, the G20 called on the "appropriate bodies" to conduct "objective peer reviews."[58] The OECD's Global Forum on Tax Transparency and Exchange of Information was designated to be the institutional "enabler"[59] of the G20 and was restructured[60] to perform the "peer reviews" aimed at evaluating and enforcing the implementation of "the international standard for transparency and exchange of information upon request."[61]

The G20 Leaders met twice in each of 2009 and 2010, then annually in each year thereafter. At the third meeting, in 2009 in Pittsburgh, the G20 Leaders' Declaration increased the pressure on member states to pursue global tax transparency.[62]

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57. *Id.* at 5.

58. *Id.* at 4.

59. For terminology, *see* Itai Grinberg, *The New International Tax Diplomacy*, 104 GEO. L. J. 1137 (2016).

60. *See* Global Forum on Transparency & Exch. Of Info. For Tax Purposes, OECD, *Information Brief* (2013) (Nov. 2013).

The Global Forum was restructured in September 2009 in response to the G20 call to strengthen implementation of the standard. The Global Forum now has 121 members and is the premier international body for ensuring the implementation of the internationally agreed standards of transparency and exchange of information on request in the tax area. The restructured Global Forum ensures that all its members are on an equal footing and will fully implement the standard on exchange of information they have committed to implement. It also works to establish a level playing field, even among countries that have not joined the Global Forum.

61. G20 London Summit, Declaration on Strengthening the Financial System, *supra* note 54, at 4. "The international standard" then contemplated is that embodied in Article 26 of both the OECD and United Nations Model Conventions, although the G20 London Declaration mentioned only the UN standard. But, it also noted that the OECD had "today published a list of countries assessed by the Global Forum against the international standard for exchange of information."

62. Thus, the Leaders stated that "[t]he main focus of the Forum's work will be to implement tax transparency and exchange of information so that countries can fully enforce their tax laws to protect their tax base," G20 Pittsburgh Summit, Leaders Statement, *supra* note 44, at 10, and later "strengthened our . . . pledge to support robust and transparent peer reviews," and to continue "addressing non-cooperative jurisdictions based on comprehensive, consistent, and transparent assessment with respect to tax havens." G20 Toronto Summit 2010, June 27, 2010, *G20 Toronto Summit Declaration*, ¶ 22, at 5 (June 27, 2010) [hereinafter G20 Toronto Summit Declaration]. At the Seoul summit, the Leaders "reiterated our commitment to preventing non-cooperative jurisdictions from posing risks to the global financial system and welcomed the ongoing efforts by the FSB, Global Forum on Tax Transparency and Exchange of Information (Global Forum), and the Financial Action Task Force (FATF), based on comprehensive, consistent and transparent assessment," and urged "jurisdictions identified as not having the elements in place to achieve an effective exchange of information should promptly address the weaknesses," and "all jurisdictions to stand ready to conclude Tax Information Exchange Agreements where requested by a relevant partner." G20 Seoul Summit 2010, Nov. 12, 2010,

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In March 2010, the United States adopted the Foreign Accounts Tax Compliance Act (FATCA), conceived as a minor revenue raising measure to offset certain stimulus spending measures in the Hiring Incentives to Restore Employment Act of 2010.[63] FATCA imposed new withholding and reporting requirements aimed at curbing offshore tax evasion by United States persons. Principally, the statute imposed a 30 percent withholding tax on all payments to "foreign financial institutions" (FFIs) unless those institutions entered into agreements with the United States Treasury to provide information concerning the customers of these FFIs who were United States persons.[64] The core of this statute reflected an effort suggested by the first two bullet points set forth in the London 2009 Declaration, and set out above.[65]

FATCA raised questions concerning the possible extraterritorial (and thus illegal) application of United States reporting requirements. In response to foreign concerns, in February 2012, the United States and certain of its trading partners issued joint statements announcing that the United States and each of the other countries would enter into two "intergovernmental agreements" (IGAs) under which the potentially extraterritorial aspects of FATCA would be eased.[66] The agreements would ease the application of many FATCA requirements, including the withholding requirement and the requirement that financial institutions enter into agreements with the Internal Revenue Service on condition of "automatic" government-to-government exchanges of information.[67] These agreements applied to nations which had legal authority (or which agreed to adopt legislation creating the authority) to collect the information subject to the FATCA requirements.[68] The United States subsequently issued "model agreements," one providing for reciprocal automatic exchange of information, the other not imposing reciprocal sharing obligations on the United States. The model agreements are updated periodically.[69]

The G20 Seoul Summit Leaders' Declaration, at 13 (Nov. 12, 2010) [hereinafter G20 Seoul Summit Leaders' Declaration].

63. FATCA was enacted as Title V of the Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147, 124 Stat. 71.

64. *Id.* at 97.

65. *See supra* note 61 and accompanying text.

66. The Treasury announced that it was considering such agreements as "an alternative approach to implementation" of FATCA, in the preamble to the first set of FATCA regulations issued in February 2012. 77 Fed. Reg. 9022, 9023 (Feb. 15, 2012). The Joint Statement from the United States, France, Germany, Italy, Spain, and the United Kingdom regarding an Intergovernmental Approach to Improving International Tax Compliance and Implementing FATCA is reproduced at *Treasury Announces Intergovernmental Framework for FATCA Implementation*, 2012 TNT 27–28 (Feb. 9, 2012); *see generally* Stanley I. Langbein, Fed. Inc. Tax. Banks & Financial Inst., ¶ 14.10[2][a] at 5–6 (7th ed. 2017).

67. *See* 77 Fed. Reg. at 9081.

68. *Id.* at 9025.

69. In June 2012, the United States, Japan, and Switzerland issued comparable joint statements announcing a different species of IGAs applicable to nations which did not have legal authority to collect the information demanded by FATCA from their own institutions. These

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At the November 2010 Seoul summit, the Leaders started to exhibit some shift in emphasis from enforcing existing international tax rules through transparency and exchange of information, to an extension of the G20 tax agenda to encompass the substantive overhaul of international tax rules.[70] At the 2011 Cannes summit, the Leaders, while continuing to stress international exchange of information and condemnation of "non-co-operative" tax havens, reflected a cognizance of the incipient impact of FATCA, as well as a growing concern with the substantive aspects of taxation.[71] As to the latter, the Leaders declared themselves "committed to protect our public finances and the global financial system from the risk posed by tax havens and non-cooperative jurisdictions."[72] As to the former, the Leaders for the first time—and some four months prior to the United States' public announcement of the first IGAs—expressed support for "automatic" exchange of information, as opposed to the former call for improvements in mechanisms for exchange of information "upon request":

> In the tax area, the Global Forum has now 105 members. More than 700 information exchange agreements have been signed and the Global Forum is leading an extensive peer review process of the legal framework (phase 1) and implementation of standards (phase 2). We ask the Global Forum to complete the first round of phase 1 reviews and substantially advance the phase 2 reviews by the end of next year . . . We underline in particular the importance of comprehensive tax information exchange and encourage competent authorities to continue their work in the Global Forum to assess and better define the means to improve it. We welcome the commitment made by all of us to sign the Multilateral Convention on Mutual Administrative Assistance in Tax Matters and strongly encourage other jurisdictions to join this Convention. In this context, *we will consider exchanging information automatically on a voluntary basis as appropriate and as provided for in the convention*.[73]

IGAs provided for direct provision of most information by the state's financial institutions to the Internal Revenue Service. The United States subsequently issued "model agreements" applicable to nations in these circumstance, again some reciprocal and some non-reciprocal, and some applicable to countries with which the United States had a prior double taxation or information exchange agreement, and another model applicable to countries with no such agreement. In the period since, the United States has developed a wide network of IGAs with foreign countries in both categories.

70. The Leaders pledged to "build sustainable revenue bases for inclusive growth and social equity by improving developing country tax administration systems and policies and highlighting the relationship between non-cooperative jurisdictions and development," G20 Seoul Summit Leaders' Declaration, *supra* note 62, at 17.

71. G20 Cannes Summit 2011, Nov. 4, 2011, *Cannes Summit Final Declaration*, (Nov. 4, 2011) [hereinafter G20 Cannes Summit Final Declaration].

72. *Id.* at 8.

73. *Id.* (emphasis added).

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By the June 2012 meeting in Los Cabos, the G20 edged away from its ongoing emphasis on transparency and exchange of information, and toward embracing the twin pillars of automatic exchange of information, and preventing "base erosion and profit shifting" (BEPS) through substantive reform:

> In the tax area, we reiterate our commitment to strengthen transparency and comprehensive exchange of information. We commend the progress made as reported by the Global Forum and urge all countries to fully comply with the standard and implement the recommendations identified in the course of the reviews, in particular the 13 jurisdictions whose framework does not allow them to qualify to phase 2 at this stage. We expect the Global Forum to quickly start examining the effectiveness of information exchange practices and to report to us and our finance ministers. *We welcome the OECD Report on the practice of automatic information exchange, where we will continue to lead by example in implementing this practice. We call on countries to join this growing practice as appropriate* and strongly encourage all jurisdictions to sign the Multilateral Convention on Mutual Administrative Assistance. We also welcome the efforts to enhance interagency cooperation to tackle illicit flows including the outcomes of the Rome meeting of the Oslo Dialogue. *We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area.*[74]

This trajectory was responsive, on the one hand, to a growing concern within G20 governments about the substantive rules behind the tax structures that were, during that time of fiscal austerity, unanimously seen as being "unacceptable," and that commenced to stir an uptick in unilateral actions, and increasingly "creative" tax audit positions in the BRICS states, especially in the People's Republic of China and India.[75] Outside

74. G20 Los Cabos, Mexico Summit, June 18–19, 2012, *G20 Leaders Declaration*, ¶ 48, at 8 (June 18–19, 2012) [hereinafter G20 Los Cabos Summit Leaders' Declaration]. Here, it is the G20 suggesting that it was "follow[ing]" the work of the OECD, not that the G20 itself that was pursuing the BEPS initiative. Later, pronouncements would reveal that it was the G20 itself that was the primary driver of the initiative.

75. U.N. DEP'T OF ECON. & SOC. AFFAIRS, U.N. PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES, ch. 10.3 (2013). Concerning Chinese attempts to address this issue in the 2008–2014 period, *cf.*, *e.g.* Dongmei Qiu, *Collecting Unpaid Tax Offshore: Caribbean Tax Havens and Foreign Direct Investment in China*, IBFD BULLETIN FOR INTERNATIONAL TAXATION, Vol. 68 (Dec. 2014).

Also germane is the six-part series *Revenge of the Source Countries*, published in 2005–2006 in TAX NOTES INTERNATIONAL. *See* Lee Sheppard, *Revenge of The Source Countries?* 37 TAX NOTES INT'L 1127 (Mar. 28, 2005); Lee Sheppard, *Revenge of The Source Countries, Part 2: Royalties*, 2005 TNT 191–7 (Oct. 5, 2005); Lee Sheppard, *Revenge of The Source Countries, Part 3: Royalties*, 40 TAX NOTES INT'L 219 (Oct. 17, 2005); Lee Sheppard, *Revenge of The Source Countries, Part 4: Who Gets The Bill?* 40 TAX NOTES INT'L 411 (Oct. 31, 2005); Lee Sheppard, *Revenge of The Source Countries, Part 5: Throwing BRICs*, 111 TAX NOTES 1455 (June 26, 2006);

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governments, on the other hand, in the general public, mainstream media coverage, rhetoric against tax avoidance, and "letter box companies" gained widespread attention.[76] These led to extensive congressional hearings on the tax strategies of large U.S. enterprises, including Apple, GE, Google, HP, Starbucks, Microsoft, and Caterpillar.[77] Importantly, too, academia provided the technical insights into the workings of global tax structures[78] as well as a buzzword ("stateless income")[79] to capture the substantive structural problems of the international tax system.

In such circumstances, politicians of the G20[80] and the delegates within the OECD Center for Tax Policy and Administration (CTPA), especially the

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Lee Sheppard, *Revenge of The Source Countries, Part 6: Subsidiary As PE*, 44 TAX NOTES INT'L 164 (Oct. 16, 2006).

76. The press reports involved initially came from a Bloomberg.com reporter named Jesse Drucker, who became somewhat famous on account of the reports, and in 2016 moved to The New York Times. The initial reports were made in 2010. Jesse Drucker, *U.S. Companies Dodge $60 Billion in Taxes With Global Odyssey*, BLOOMBERG, May 13, 2010, http://www.bloomberg.com/news/2010-05-13/american-companies-dodge-60-billion -in-taxes-even-tea-party-would-condemn.html (tax activities of Forest Laboratories); Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, BLOOMBERG, Oct. 21, 2010, http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion- u-s-revenue-lost-to-tax-loopholes.html. The press reports after that were largely outside the United States, and indeed were most prevalent in Ireland, which had a deep interest in them as its law was the basis of many of the avoidance structures used, and Australia, which has some leanings in conflict with OECD official policy advocating the "arm's length" standard, as well as in Japan, France, Germany, and the United Kingdom. *See, e.g.*, Richard Waters, *Tax Drives US Tech Groups to Tap Debt*, FINANCIAL TIMES, Feb. 6, 2011, p. 15 Col. 6 (activities of Microsoft Corporation). The first major news report in the United States, in print, appears to have been in April 2012 in the Sunday *New York Times*. Charles Duhigg and David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, THE NEW YORK TIMES, p. 1, Apr. 29, 2012.

77. *Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Gov't Affairs*, 113th Cong (2013); *Caterpillar's Offshore Tax Strategy, Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Gov't Affairs*, 113th Cong, (2014).

78. *See, e.g.*, *Vann Hard-Boiled WonderWorld.*

79. *See Kleinhard*, *supra* note 11.

80. The finance ministers and central bank governors of the G20 met in Mexico City in early November 2012, and at that meeting, the ministers of the United Kingdom and Germany agreed on a plan to finance an effort to curb "base erosion and profit sharing." *See* Patrick Wintour & Dan Milmo, *UK and Germany Agree Crackdown on Tax Loopholes for Multinationals: Osborne and Schauble Tackle "Profit Shifting" Changes in E-Commerce Leave Governments Trailing*, THE GUARDIAN, p. 2. (Nov. 6, 2012). Later that month, joined by the finance ministry of France, the ministers of the three nations sent a letter to the OECD, pledging funds for an effort against "profit shifting," and asking for "concrete results" by the time of the next G20 ministerial level meeting, scheduled for Moscow in February 2013. The OECD produced the report February 13, 2013, and the ministerial meeting in Moscow approved the report and directed the OECD to produce a detailed "action plan" by July 2013. *See* OECD, *Addressing Base Erosion and Profit Shifting* (2013), [hereinafter Addressing Base Erosion]. The OECD produced the Action Plan on schedule, and it was this document that first identified the fifteen areas for study that would comprise the BEPS initiative. OECD, *Action Plan on Base Erosion and Profit Shifting* (2013) [hereinafter 2013 OECD Action Plan]. The finance ministers approved the Action Plan at a ministerial meeting in Moscow July 20, 2013. *See OECD Announces Action*

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If there is no adverse possession of chattels in New Jersey, there can be no concern that HEAR would unconstitutionally take property when it lengthens the statute of limitations.

That would leave two possibilities. If claimant does not establish that he was sufficiently diligent to benefit from the discovery rule, the cause of action would accrue when the work was stolen and brought into New Jersey.[286] HEAR would postpone that accrual until the claimant actually knew what he needed to know to sue.[287] The six years provided by New Jersey law and the six years provided by HEAR would be the same, but the later accrual would be significant in many cases.

If claimant establishes that he was sufficiently diligent to use the discovery rule, HEAR is still likely to extend the statute of limitations unless the time when claimant actually discovers what he needs to know is the same moment that he should have discovered it. In that limited case, the time provided by HEAR and New Jersey law would be the same. If the facts are actually discovered later than they should have been discovered, HEAR will provide the same amount of extra time to bring suit.

If, on the other hand, New Jersey has something like adverse possession for chattels, any possession that ripened into title before December 16, 2016, will be protected from HEAR by the takings clause of the constitution. But, such a result has its own set of problems. It is unlikely that it can be determined whether adverse possession has occurred without significant discovery and a trial on that issue. This is because those questions call for judgments about reasonability of diligence and what one should have learned, which usually cannot be resolved without a trial.

For current possessors whose possession did not ripen into title by adverse possession, the result will be as set forth above if New Jersey has abolished adverse possession for personalty.

c. California Actual Discovery Rule & Six-Year Statute for Art Professionals, Discovery Rule, and Three-Year Statute for Other Current Possessors

The effect of HEAR in California is a bit complicated because California has a number of different statutes of limitations for the recovery of personal property, two of which apply to the property protected by HEAR.[288] An action to recover property of historical, interpretive, scientific, or artistic significance taken by theft invokes the discovery rule, requiring suit within three years of the time the diligent owner discovered or should have discovered what he needs to know.[289] But, a suit brought before December

286. The universal rule is that the statute of limitations does not run when the work is outside the jurisdiction or when the work is being fraudulently concealed.
287. HEAR, *supra* note 1, at § 4.
288. The general rule is three years from the time the cause of action accrues, presumably the time of the taking. *See* CAL. CODE CIV. PROC. § 338(c)(1) (2016).
289. *See* CAL. CODE CIV. PROC. § 338(c)(2) (2016). This provision was enacted by Stats. 1982, c. 340, p. 1642 § 3.

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> *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*. In order to minimize BEPS, we call on member countries to examine how our own domestic laws contribute to BEPS and to ensure that international and our own tax rules *do not allow or encourage multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions*. We acknowledge that effective taxation of mobile income is one of the key challenges. We look forward to regular reporting on the development of proposals and recommendations to tackle the 15 issues identified in the Action Plan and commit to take the necessary individual and collective action with the paradigm of sovereignty taken into consideration.[86]

The 2013 Saint Petersburg Declaration paired this expression with unequivocal endorsement of "automatic exchange" of information:

> We commend the progress recently achieved in the area of tax transparency and we fully endorse the OECD proposal for *a truly global model for multilateral and bilateral automatic exchange of information*. Calling on all other jurisdictions to join us by the earliest possible date, *we are committed to automatic exchange of information as the new global standard*, which must ensure confidentiality and the proper use of information exchanged, and we fully support the OECD work with G20 countries aimed at presenting such *a new single global standard for automatic exchange of information* by February 2014 and to finalizing technical modalities of effective automatic exchange by mid-2014. In parallel, *we expect to begin to exchange information automatically on tax matters among G20 members by the end of 2015*. We call on all countries to join the Multilateral Convention on Mutual Administrative Assistance in Tax Matters without further delay. *We look forward to the practical and full implementation of the new standard on a global scale*. We encourage the Global Forum to complete the allocation of comprehensive country ratings regarding the effective implementation of information exchange upon request and ensure that the implementation of the standards are monitored on a continuous basis. We urge all jurisdictions to address the Global Forum recommendations in particular those 14 that have not yet moved to Phase 2. We invite the Global Forum to draw on the work of the FATF with respect to beneficial ownership. We also ask the Global Forum to *establish a mechanism to monitor and review the implementation of the new global standard on automatic exchange of information*.[87]

86. G20 Saint Petersburg Summit, Sept. 6, 2013, *G20 Leaders' Declaration*, ¶ 50 (Sept. 6, 2013) [hereinafter G20 Saint Petersburg Summit Leaders' Declaration].
87. *Id.* ¶ 51 (emphasis added).

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The Saint Petersburg Declaration adumbrated a third concern, with the impact of adverse tax practices on developing countries, and with ensuring those nations derive benefit from the new global standard of automatic information exchange:

> Developing countries should be able to reap the benefits of a more transparent international tax system, and to enhance their revenue capacity, as mobilizing domestic resources is critical to financing development. We recognize the importance of all countries benefitting from greater tax information exchange. *We are committed to make automatic exchange of information attainable by all countries, including LICs, and will seek to provide capacity building support to them*. We call on the Development Working Group in conjunction with the Finance Track, to work with the OECD, the Global Forum and other IOs to develop a roadmap showing how developing countries can *overcome obstacles to participation in the emerging new standard in automatic exchange of information*, and to assist them in meeting the standard in accordance with the action envisaged in the St Petersburg Development Outlook. The Working Group should report back by our next meeting. Working with international organisations, we will continue to share our expertise, help build capacity, and engage in long-term partnership programmes to secure success. In this respect, we welcome the OECD Tax Inspectors without Borders initiative, which aims to share knowledge and increase domestic capacities in developing countries in the tax area. Finally, we are committed to continue to assist developing countries, including through the IOs, in identifying individual country needs and building capacity in the area of tax administration (in addition to automatic exchange of information) and encourage such support to be developing country led.[88]

At the 2014 summit in Brisbane, Australia, amidst ongoing technical work on developing precise responses to the 15-point Action Plan within the OECD CFA, the Leaders reiterated these three points, expressly endorsed the value creation concept, and perhaps taking a swipe at the key procedural adjunct of the arm's length standard, as implemented by an emphasis on "contractual allocations,"[89] *viz.*, the advanced pricing agreement (APA) practice:

> We are taking actions to ensure the fairness of the international tax system and to secure countries revenue bases. *Profits should be taxed where economic activities deriving the profits are performed and where value is created*. We welcome the significant progress on the G20/OECD Base Erosion and Profit Shifting (BEPS) Action Plan to modernise international tax rules. We are committed to finalising this work in 2015, *including transparency of taxpayer-specific rulings found to constitute*

88. *Id.* ¶ 52 (emphasis added).
89. *See infra* Part III.C.D.

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> *harmful tax practices*. We welcome progress being made on taxation of patent boxes. To prevent cross-border tax evasion, we endorse the global Common Reporting Standard for the automatic exchange of tax information (AEOI) on a reciprocal basis. We will begin to exchange information automatically with each other and with other countries by 2017 or end-2018, subject to completing necessary legislative procedures. We welcome financial centres' commitments to do the same and call on all to join us. We welcome deeper engagement of developing countries in the BEPS project to address their concerns. We will work with them to build their tax administration capacity and implement AEOI. We welcome further collaboration by our tax authorities on cross-border compliance activities.[90]

The 2015 communiqué from the summit in Ankara, Turkey, endorsed the final BEPS reports and emphasized the importance of their implementation as well as the involvement of non-G20 countries in this process, with continuing stress on commitments to developing countries.[91] It also suggested a dubious view of the APA process, despite the fact that any such view is hardly detectable in the BEPS Action Plan or the various final BEPS reports:

> To reach a globally fair and modern international tax system, we endorse the package of measures developed under the ambitious G20/ OECD Base Erosion and Profit Shifting (BEPS) project. *Widespread and consistent implementation will be critical in the effectiveness of the project, in particular as regards the exchange of information on cross-border tax rulings*. We, therefore, strongly urge the timely implementation of the project and encourage all countries and jurisdictions, including developing ones, to participate. To monitor the implementation of the BEPS project globally, we call on the OECD to develop an inclusive framework by early 2016 with the involvement of interested non-G20 countries and jurisdictions which commit to implement the BEPS project, including developing economies, on an equal footing. We welcome the efforts by the IMF, OECD, UN and WBG to provide appropriate technical assistance to interested developing economies in tackling the domestic resource mobilization challenges they face, including from BEPS. We acknowledge that interested non-G20 developing countries" timing of implementation may differ from other countries and expect the OECD and other international organisations to ensure that their circumstances are appropriately addressed in the framework. We are progressing towards enhancing the transparency of our tax systems and we reaffirm our previous commitments to

90. G20 Brisbane Summit, Nov. 16, 2014, *G20 Leaders' Communiqué Brisbane Summit*, ¶ 48, (Nov. 16, 2014) (emphasis added) [hereinafter G20 Brisbane Summit Leaders' Communique].

91. G20 Antalya Summit, Nov. 15-16, 2015, *G20 Leaders' Communiqué, Antalya Summit, 15–16 November 2015*, ¶ 15, (Nov. 16, 2014) (emphasis added) [hereinafter G20 Antalya Summit Leaders' Communique].

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> information exchange on-request as well as to automatic exchange of information by 2017 or end-2018. We invite other jurisdictions to join us. We support the efforts for strengthening developing economies' engagement in the international tax agenda.[92]

The 2016 communiqué, from the summit in Hangzhou, China, reaffirmed commitment to the twin pillars, calling emphatically for co-operative and "consistent" BEPS implementation, at the same time recognizing newly designed mechanisms for promoting co-operation, including administrative assistance to developing countries.[93] However, that declaration included some new themes, especially the encouragement of "pro-growth" tax policies, and identification of the relationship to such policy of the twin pillars, as well as a new emphasis on the role of China:

> We will continue our support for international tax cooperation to achieve a globally fair and modern international tax system and to foster growth, including advancing on-going cooperation on base erosion and profits shifting (BEPS), exchange of tax information, tax capacity-building of developing countries and tax policies to promote growth and tax certainty. We welcome the establishment of the G20/OECD Inclusive Framework on BEPS, and its first meeting in Kyoto. *We support a timely, consistent and widespread implementation of the BEPS package and call upon all relevant and interested countries and jurisdictions that have not yet committed to the BEPS package to do so and join the framework on an equal footing*. We also welcome the progress made on effective and widespread implementation of the internationally agreed standards on tax transparency and reiterate our call on all relevant countries including all financial centers and jurisdictions, which have not yet done so *to commit without delay to implementing the standard of automatic exchange of information by 2018 at the latest and to sign and ratify the Multilateral Convention on Mutual Administrative Assistance in Tax Matters*. We endorse the proposals made by the OECD working with G20 members on the objective criteria to identify non-cooperative jurisdictions with respect to tax transparency. We ask the OECD to report back to the finance ministers and central bank governors by June 2017 on the progress made by jurisdictions on tax transparency, and on how the Global Forum will manage the country review process in response to supplementary review requests of countries, with a view for the OECD to prepare a list by the July 2017 G20 Leaders" Summit of those jurisdictions that have not yet sufficiently progressed toward a satisfactory level of implementation of the agreed international standards on tax transparency. Defensive measures will be considered against listed jurisdictions. We encourage countries and international

92. G20 Antalya Summit, Nov. 15–16, 2015, *G20 Leaders' Communiqué, Antalya Summit, 15-16 November 2015*, (Nov. 16, 2015).
93. G20 Hangzhou Summit, Sept. 5, 2016, *G20 Leaders' Communiqué, Hangzhou Summit, Hangzhou, China, September 5, 2016*, (Sept. 5, 2016).

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Laches has two requirements: unreasonable delay and resulting detriment. Unreasonable delay is not measured simply by time, though a matter of years is usually required before delay is unreasonable, while a matter of months is seldom sufficient. Unreasonable delay depends on the facts of the case, one court suggesting that a twenty-year delay might be reasonable in reporting a loss if it was thought that public knowledge of the loss would send the missing artwork underground and make it more difficult to find.[300] It seems also to depend very much on the second requirement, that the defendant has changed his position to his detriment as a result of the delay.[301]

Unreasonable delay can be attributed to claimants, or to their predecessors in interest, and this is true even though claimants or their ancestors were unaware of their rights if they should have known them.[302] Because a court is likely to attribute to claimants knowledge that they would have discovered had they been duly diligent, current possessors will try to prove that claimants were not duly diligent in seeking their artworks. Claimants will allege their reasonable diligence. Alternatively, they will argue that they would not have discovered what they need to know if they had been more diligent. In short, some of the material that HEAR makes irrelevant for statute of limitations purposes by making HEAR an actual discovery statute creeps back into consideration in laches.

There are two kinds of detriment that might result from delay in bringing suit. One is that witnesses or other evidence might no longer be available. Courts have not required that the witnesses would have testified for the current possessor; it is enough that a witness who could explain whether the property was stolen or not or other circumstances can no longer testify.[303]

The other detriment is that the current possessor or his predecessor may have changed his position to his detriment in reliance on his ownership. One example might be if he invested in conservation of the work. One court has opined that this requirement might be satisfied if the work greatly

confidentiality, but the claimants were not. *See id.* Judge Rakoff approved the confidentiality of the settlement with great reluctance. *See id.* at 6. More detail on the case is provided at O'DONNELL, *supra* note 292, at 203–215. For an illustration of some of the difficulties of proving and defending against a laches allegation, *see* Solomon R. Guggenheim Found. v. Lubell, 153 A.D.2d 143, 151-52 (N.Y. App. Div. 1990).

300. Solomon R. Guggenheim Found. v. Lubell, 569 N.E.2d 426 (N.Y. 1991) (dictum).

301. *See* Ricciardi v. Johnstown Leather, 1 A.D.3d 661, 663 (N.Y. App. Div. 2003) (4 months not enough); Weiss v. Mayflower Doughnut Corp., 135 N.E.2d 208, 212 (N.Y. 1956) (dictum that 3 months is not enough).

302. *See* Bakalar v. Vavra, 819 F. Supp. 2d 293, 303-306 (S.D.N.Y. 2011), *aff'd*, 500 F. App'x 6 (2d Cir. 2012) (per curiam); Schoeps v. Museum of Modern Art, 594 F. Supp. 2d 461, 467 (S.D.N.Y. 2009); *In re* Estate of Barabash, 286 N.E.2d 268, 271 (N.Y. 1972) (laches denied when party had no reason to know of his rights).

303. *See Bakalar*, 819 F. Supp. 2d at 306 (witness dead); *Wertheimer*, 300 A.D.2d at 118 (witnesses dead).

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performing the economic activity,"[266] and that "transfer prices are supposed to reflect the contribution of the activity and assets utilized in each location to economic income."[267] But instead of an acknowledgment of the failure of the contemporaneous arm's length standard fostered in the 1960s, the White Paper—referencing the "zero profit" thesis—sought to diminish the significance of the continuum price problem.[268]

Nevertheless, the White Paper implicitly confirms that "source taxation" is a function of the "value creation" of the firm and that it should be priced "correctly" to effectuate the idea of allocating business profits. But, it does so by employing an exclusively "production cost" logic to measure the "economic contributions to income." To the Treasury, the "continuum price problem" was rightly defined as "a situation in which the sum of the returns for separate services rendered by independent parties is less than the actual return of the combined group," but wrongly assumed to be exclusively a consequence of firms utilizing *production technology*.[269] Consistent with this logic, the White Paper proposed a solution which perceived the integration savings to organisations solely as a return to intangible capital. Therefore, the intangible capital owning group entity should be allocated the residual return, if necessary, through application of the BALRM or the "profit split method" (PSM). The PSM, which the Paper said should be used if both parties "*owned*" significant intangible capital,[270] was set to "identify the intangible income attributable to the relevant line of business and then split that income according to *the relative value* that the marketplace would put on each party's significant intangible assets had they been employed by independent parties operating at arm's length."[271]

In brief, Treasury's reaction displayed

(i) that the "continuum price problem" exists and that it is essentially a "value creation" and a "source" taxation problem, and thereby implicitly confirmed that internal "value creation" was principally a valid category of framing the discussion on the goals tax transfer pricing in a source-based international tax system should achieve; but
(ii) approached this problem by employing market theories which are questionable in real-life markets ("zero profit theory") and which created, through a narrow "production cost logic," a system inappropriate in a firm value creation context.

This entails two major caveats:

(i) the assumption that intangible capital ownership would attract the residual profits of a firm effectively re-characterizes an internal

266. *United States Treasury Dep't*, *supra* note 207, at 122 (emphasis added).
267. *Id.* at 123.
268. *Id.* at 128.
269. *Id.* at 123.
270. *Id.* at 160-161.
271. *Id.* at 164.

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B. The Twofold "Negative" Connotation of the "Value Creation Paradigm"

The foregoing detailed the trajectory of the Group of 20 Leaders' pronouncements about the commitment of that group of nations to the BEPS project and the related campaign for automatic exchange of information. Both of these represented innovations of principle in the interpretation of the provisions of the worldwide network of bilateral double taxation conventions, most based structurally upon the OECD Model Convention.

But, the core technical analysis of the OECD underlying this trajectory, undertaken "in response to concerns raised by the G20,"[99] and ultimately expressed in the value creation paradigm is entailed in the Addressing Base Erosion and Profit Shifting Report issued in February 2013.[100] In this Report, the OECD does not expressly define what it perceives as BEPS—which, in fact, the OECD never did[101]—but embarks on a descriptive approach to capture a "phenomenon" that raises tax "policy concerns."[102] The Report references "a growing perception that governments lose substantial corporate tax revenue because of planning aimed at shifting away profits in ways that erode the taxable base to locations where they are subject to a more favorable tax treatment,"[103] and sees "opportunities to eliminate or significantly reduce taxation on income in a manner that is inconsistent with the policy objectives of domestic rules and international standards."[104]

In searching for "indications" for the "existence and magnitude of BEPS,"[105] the OECD finds exemplary low-tax jurisdictions that each, although having miniscule gross domestic products, received (inbound) and made (outbound) more foreign direct investments in a volume greater than some of the largest economies in the world (including Germany). Turning

99. *Id.*
100. Addressing Base Erosion, *supra* note 80.
101. To the best of our knowledge, only the EU-Commission has ever defined "aggressive tax planning." *See Commission Recommendation of 6.12.2012 on Aggressive Tax Planning*, at 2, COM (2012) 8806 final (June 12, 2012) (emphasis added):
A key characteristic of the practices in question is that they reduce tax liability through *strictly legal arrangements which however contradict the intent of the law* . . . Aggressive tax planning consists in taking advantage of the technicalities of a tax system or mismatches between two or more tax systems for the purpose of reducing tax liability.
102. The emphasis that the Joint Committee places on the "G20 concerns" refers also to the UN Practical Manual on Transfer Pricing and to European concerns, *e.g.*, such as voiced with specific regard to "value creation" concerns by the French Government; *see* Task Force on the Digital Economy, *Report to the Minister for the Economy and Finance, the Minister for Industrial Recovery, the Minister Delegate for the Budget and the Minister Delegate for Small and Medium-Sized Enterprises, Innovation and the Digital Economy*, January 2013 (the so-called "Collin/Colin-Report"), *available at* http://www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf. *See* Joint Comm. OECD/G20 Background, *supra* note 98, at 8.
103. Addressing Base Erosion, *supra* note 80, at 13.
104. *Id.* at 15.
105. *Id.*

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to the globe's largest recipient and distributor of foreign direct investment, the Netherlands, the Report finds roughly 75 percent of the total amount of foreign direct investment being channeled through "special purpose entities," which are defined as every

> [enterprise that] meets the following criteria: (i) The enterprise is a legal entity, a. Formally registered with a national authority; and b. Subject to fiscal and other legal obligations of the economy in which it is resident. (ii) The enterprise is ultimately controlled by a non-resident parent, directly or indirectly. (iii) The enterprise has no or few employees, little or no production in the host economy and little or no physical presence. (iv) Almost all the assets and liabilities of the enterprise represent investments in or from other countries. (v) The core business of the enterprise consists of group financing or holding activities, that is – viewed from the perspective of the compiler in a given country – the channeling of funds from non-residents to other non-residents. However, in its daily activities, managing and directing plays only a minor role.[106]

Taking these "indications" for "BEPS," the Report describes a tax policy concern as "BEPS" that is composed of passive SPEs being employed to channel foreign direct investments and, thus, having profits on those investments technically accrue to entities in low-tax jurisdictions.[107] The Report finds its analysis supported by a number of studies and data indicating that there is increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes. Actual business activities are generally identified through elements such as sales, workforce, payroll, and fixed assets.[108]

Concluding that "circumstantial evidence" for BEPS exists and having roughly described its basic content, the Addressing BEPS Report continues to analyze the legal mechanisms that lead to possibilities for "increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes."[109] It finds that "current rules provide opportunities to associate more profits with legal constructs and intangible rights and obligations, and to legally shift risk intra-group, with the result of reducing the share of profits associated with substantive operations."[110] The Report identifies the "underlying assumptions of the arm's length [standard]"[111] as the cause of

106. *Id.* at 22, n.6.
107. *Id.* at 40. Again, while commonsense might call this BEPS off-the-cuff, in legal terms this is "managed profit accrual" permitted by (flawed) operative laws, so that calling it "profit shifting" shifts important parts of the blame.
108. *Addressing Base Erosion*, *supra* note 80, at 20.
109. *Id.* at 15.
110. *Id.* at 33.
111. *Id.* at 42.

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such "profit shifting" and finds it problematic to base the determination of transfer prices on "contractual allocation of risks and intangibles."[112]

> With regard to possible solutions to "BEPS," the Report sets forth "key pressure areas" and announces the intention to develop a "comprehensive action" plan, with the "main purpose"[113] of providing instruments for governments to use in "better aligning rights to tax with real economic activity"[114] (*i.e.*, "elements such as sales, workforce, payroll, and fixed assets"), and which would "realign international standards with current global business environment."[115] This "global business environment" is, according to the Addressing BEPS report, characterized by the rise of global value chains (GVCs) in which "separate legal entities forming the group operate as a single integrated enterprise following an overall business strategy. Management personnel may be geographically dispersed rather than being located in a single central location, with reporting lines and decision-making processes going beyond the legal structure of the MNE."[116]

Within the GVCs, the Report discerns typological differences in the importance of value contributions of stages of production, holding that "[f]rom an economic point of view, most of the value of a good or service is typically created in upstream activities where product design, R&D or production of core components occur, or in the tail-end of downstream activities where marketing or branding occurs."[117]

The Report further states that achieving the goal of "better aligning rights to tax with real economic activity" and "realign[ing] international standards with current global business environment" requires revisiting "some of the fundaments of the existing standards" and that "incremental approaches may help curb the current trends, but will not respond to several of the challenges."[118] Specifically in the realm of transfer pricing, the Report calls for "improvements or clarifications"—without pledging allegiance to the arm's length standard—in order to address "areas where current rules produce undesirable results from a policy perspective"[119] and that the on-going discussions on intangibles were to be "included in a broader reflection on transfer pricing."[120]

The potential solutions to "BEPS" were specified in the *Action Plan On BEPS* issued in June 2013. The *Action Plan* again states that the arm's length standard in many instances allocates the income of MNEs "effectively and

112. *Id.* at 42.
113. *Id.* at 51.
114. *Id.* at 51 (emphasis added).
115. *Id.* at 51.
116. *Id.* at 25.
117. *Id.* at 27.
118. *Id.* at 51.
119. *Id.* at 52.
120. *Id.* at 10, 52.

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efficiently," but admits that it could be "used and/or misapplied" in a way that results in "separat[ing] income from economic activity that produce that income."[121] But contrary to the *Addressing BEPS* Report, which had been skeptical about "incremental approaches," the *Action Plan* stresses "the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system" would compel countries to refrain from "seeking to replace the current transfer pricing system," and that "the best course is to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalisation."[122] Action Points 8-10,[123] thus, set as its objectives to "assure that transfer pricing outcomes are in line with value creation," which meant that "profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation,"[124] and to "ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital."[125]

The *Addressing BEPS* Report and the *Action Plan On BEPS*, as we read them, thus, established the goal of "aligning transfer pricing outcomes with value creation" having two specific "negative" functions in mind:

- (i) to forestall excessive taxable profits being allocated to passive SPEs; and
- (ii) to mitigate the prior language of the *Addressing BEPS* Report that too strongly resembled outright formulary ideas.[126]

Clearly put, the tax policy impetus that was expressed by "aligning transfer pricing outcomes with value creation" was directed at transfer pricing structures that contractually allocated passive factors of the GVCs to SPEs

121. *OECD 2013 Action Plan*, *supra* note 80, at 19.

122. *Id.* at 20.

123. *See infra* app.

124. *OECD 2013 Action Plan*, *supra* note 80, at 20.

125. *Id.* at 20.

126. Indeed, Mayra Lucas, transfer pricing advisor at the OECD, told that a switch to formulary apportionment was in fact openly considered at the outset of the BEPS project. Dana L. Glenn, *Formulary Apportionment No Solution to BEPS, OECD Rep Says*, 142 TAX NOTES INT. 800 (Feb. 24, 2014). Still, CbC-reporting might be a step further towards formulary apportionment or a FA-close regime, tax administrations might use the data gained to reconsider its feasibility. Robert Stack told Tax Analysts that "when he agreed to include the concept of value creation in the tax paragraph of the 2013 G20 leaders' declaration, he did not view the term as significantly different from the analysis of functions, assets, and risks." In the same article, Stack is cited saying that "he understands criticism that the approach is not consistent with the arm's length principle, but that it was necessary for a greater purpose," and that a "single-entity approach to multinationals" would find its way into "some tax policies." David D. Stewart, *'Value Creation' Understanding Key to Transfer Pricing's Future*, 148 TAX NOTES INT. 390 (July 27, 2015).

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in tax havens, which entailed a problematical characterisation of such entities as entrepreneurs and to which the residual income accrues.[127]

But again, the points to stress are that the BEPS project was (1) motivated by concern about the accumulation of taxable profits in "central" subsidiaries organized in low-tax jurisdictions; and (2) adopted the "value creation" paradigm as the central tenet in approaching this problem. A subsidiary but important point was that as early as the *Action Plan*—the second of four steps in the evolution of the final reports—there was movement from a call for more drastic reform (the rejection of incremental approaches in the *Addressing BEPS* Report, and its emphasis on the factors (sales, payroll, fixed assets) traditionally used in formula apportionment) to the greater tolerance of received practices in the *Action Plan*.

II. Background and Validity of the Paradigm: The Origins

A. "Economic Allegiance,""Arm's Length," and the Validity of the "Value Creation Paradigm"

The purpose of the previous section was to show how "aligning transfer pricing outcomes with value creation" as a paradigm was introduced in response to transfer pricing outcomes that were "unacceptable from a policy perspective." We called this the "negative" prong of the value creation paradigm because it pertains to *excluding* from the international tax system.

- (i) the unacceptable transfer pricing outcome of increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes;[128] and
- (ii) open deviations from the arm's length standard (*e.g.*, formula apportionment).

Given the pivotal importance of the paradigm, the purpose of this section is to trace the historic and theoretical background of "the idea of align[ing] transfer pricing outcomes with value creation" in the evolution of the international regime for allocating business income. A review of this

127. Hence, looking back in history, one may ask if Thomas Adams' critique of the theory of "economic allegiance" developed by the Academic Experts in the 1920s does apply equally to value creation paradigm:

> This theory [is] little more than a generalized label covering a number of separate judgments which the authors of the theory have reached about the expedient place to tax certain persons or transactions . . . [b]ut their justification are practical not 'scientific,' and 'economic allegiance' is distinctly different in different states. The theory leads many of its advocates to endorse exaggerated claims concerning the rights of the jurisdiction of domicile. These exaggerated claims rest partly on the fact that their advocates are citizens of creditor states.

Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L. J. 1021, 1092 (1997) (quoting T.S. Adams, *Interstate and International Double Taxation*, Lectures on Taxation 101 (Roswell Magill ed., 1932)).

128. *Id.* at 20.

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background shows that it is a theoretically valid paradigm and is implicit in the "classification and assignment approach" recognized to be the central tenet of the rules that have governed international tax relations since the 1920s. This approach treats active business income as having its predominant economic allegiance to a source country. A further aim is to demonstrate that as such, and as originally interpreted by the G20 and at least the initial BEPS documents, it represents one strand in approaching the arm's length standard, a recognized norm for interjurisdictional allocation of the income of a transnational integrated group. We will argue that the arm's length standard as interpreted for most of this period represents an alternative strand, but that strand only partly and incoherently captures the economic facts of value creation. Thus, we argue that the value creation tradition—as opposed to a contractual allocation/one-sided method tradition—better represents the core meaning of both the classification and assignment economic allegiance approach, and of the arm's length standard which is a major facet of that approach.

As such, this discussion seeks to contribute to the question whether the paradigm constitutes a "substance rule" in interpreting existing treaty law or if it constitutes a substantive change. This section does not yet address the ultimate question where value is created from an economic perspective or how a potential theoretical framework weighing the value creating activities can be made operative, but it argues that value creation provides a valid expression of the underlying purpose of the international transfer pricing regime.

In this regard, this section argues, first, that because the original premises of assigning the right to tax business income at source were ideas akin to "aligning taxation with value creation" and because transfer pricing, though technically assigning taxing rights to a "residence" country, in effect is an economic "sourcing tool,"[129] the international transfer pricing system should be geared to produce outcomes that are aligned with rather divorced from value creation. The original ideas also contain hints—even if scant—as to how value creation is to be understood—*i.e.*, from the taxpayer's perspective, not from the perspective of the jurisdictions' burdens leading to the comparability analysis and market analogies that eventually created the opportunities for BEPS.

Second, this section argues that *ante*-BEPS, the arm's length standard has been only partially devised to achieve this goal, and serves it only imperfectly, if at all. Indeed, it is revealing that the reference to the "relative economic contributions" to value creation has found its way into the nomenclature of the transfer pricing system in connection with the profit split method. United States courts developed this method in application of unspecified methods under the United States regulations promulgated in the 1960s, which enabled those courts to manage, if not correct, the flaws of the

129. *See* Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 46-47 (1993).

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narrow arm's length system the 1960s regulations created. Still, the notion of value creation in the profit split methodology has been part of an incoherent system based on contractual assignments and of uncertain characterisations of entities, activities, or functions as "non-routine" *viz.* "entrepreneurial." As further discussed within, adjusting for or correcting misalignments between economic value of functions and their characterisation for tax transfer pricing purposes also underlay arguments for more recent developments immediately predating the BEPS initiative, especially the 2008 Authorized OECD Approach (AOA) concerning determination of the profits attributable to permanent establishments;[130] the 2010 OECD business restructurings Report;[131] and the 2012 OECD intangibles draft.[132]

In summary, we argue in this section that from both a theoretical and a policy perspective, "aligning taxation with value creation"—although clearly developed with regard to practical concerns and not really convincingly justified by the OECD/G20—is a valid paradigm that effectuates the underlying principle of economic allegiance. This tells us that

- (i) the OECD/G20 initiative developed in principle the correct measure to the transfer pricing system, and that
- (ii) the transfer pricing system as a sourcing tool should from both a policy and a doctrinal perspective capture the true economic effect of actual transactions undertaken.

This section, thus, implicitly takes a position on the underlying question whether the profit allocation under the Article 9 arm's length principle should be a mere anti-avoidance tool or a substantive tax base allocation tool.

B. Value Creation and the Early Conception Of International Business Taxation At Source: The 1923 Addendum

The League of Nations' 1920 Brussels Financial Conference identified the problems of double taxation and tax evasion[133] as pressure areas in relation to the reestablishment of post-war economic order, and in 1921 delegated to the Financial Committee of the League of Nations the task of discovering possible ways of solving this problem.[134] The Financial Committee found it

130. *See infra* Section IV.A.
131. *See infra* Section IV.B.
132. *See infra* Section IV.C.
133. League of Nations: Committee of Technical Experts on Double Taxation and Tax Evasion, Double Taxation and Tax Evasion: Report Document C. 216. M. 85, art., reprinted at Conventions Legislative History 4111, at 4119 [hereinafter 1927 Technical Experts Report].
134. *See* the "extract" of *Double Taxation and Tax Evasion—Report and Resolutions Submitted by the Technical Experts to the Financial Committee of the League of Nations*, Document F.212 (Feb. 7, 1925), reprinted in Conventions Legislative History 4057, at 4107 [hereinafter 1925 Report of First Technical Experts Committee]. The extract has no page number in the original, and is dated June 8, 1925.

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arm's length and possibly in the direction of formula apportionment—was a more advanced position than that of the international community, including the United States' major trading partners and particularly the OECD. Such an impression was understandable. In the first place, the reconsideration of the rules had clearly been instigated by the United States Congress, particularly by the 1986 Conference Report, with its derogation of the existing rules.[331] Furthermore, the Congress enacted the "super royalty provision," which obviously posed a question as to its compliance with arm's length. Moreover, the White Paper's tone was somewhat sheepish throughout in its claim that the novel approaches it detailed were fully consistent with the arm's length standard. By contrast, the OECD's pronouncements unceasingly and pointedly claimed fealty to the international standard, in tones conventionally and repeatedly described with words like "ringing endorsement."

But a closer inspection of the actual content of the proposed rules and the comments they elicited, together with an inspection of the directions which the academic and professional critics of arm's length were then advocating, lends fairly convincing evidence that any such general impression was wrong. Indeed, the critics had the situation backward. By the mid-1990s, the critics of arm's length were not advocating any full-fledged international formula method along the lines used by the states of the United States. Rather, they advocated using traditional methods to make marginal allocations to the various components of a transnational integrated group with the residual profit allocated according to fixed and determined criteria, which would not vary taxpayer to taxpayer.[332] The final United States regulations undermined any such general approach with the "best method" rule, which confined any allocation to the use of a single, best method.[333] Even when a residual profit split method was employed, the regulations tied up its use with vague standards as to the manner of allocating the residual and cautionary rules about demonstrating the superior reliability of the data employed.[334] By contrast, the OECD's express views exhibited a much greater openness to the structure of the approach which the critics of arm's length supported, particularly by accepting the use of different methods to construct an arm's length range, and by more realistic views both of the utility of the profit split method and of the manner in which various species of profit splits had been employed as "fourth" or "other" methods under the 1968 United States and 1979 OECD rules.[335]

331. H.R. Conf. Rep. No. 841. 99th Cong., 2d Sess. 11-638 (1986).

332. Stanley I. Langbein, *A Modified Fractional Apportionment Proposal for Tax Transfer Pricing*," TAX NOTES, 719 (Feb. 10, 1992); *Cf.* Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, FLA. TAX REV., 497 (2009).

333. Treas. Reg. §1.482, 59 Fed. Reg. 34971-01, 34973 (1994).

334. *Id.* at 34974.

335. 1993 OECD Letter, *supra* note 286, at 5, 8.

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> compromise must be adopted. If the first three principles are of overwhelming importance as compared with the fourth, *i.e.*, if situs and the place of enforcement re-enforce the place of origin to such an extent as to make it far more important than domicile, the presumption is clearly in favour of the composite principle of origin being predominant.[140]

Thus, by weighing these elements with regard to different classifications of wealth, the Experts concluded that the "*origin of wealth*" must be, in theory, the decisive criterion for taxing international "business enterprises" and, as such, the "place of origin" shall have the preponderant right to tax income from "commercial establishments."[141] The "place of origin" was considered to be "the place where the earnings are created,"[142] and used as a synonym to the production of wealth, which was seen as "all the stages which are involved up to the point when wealth is coming to fruition," or, differently put, "the place where wealth is produced" as "the community the economic life of which makes possible the yield or the acquisition of the wealth."[143] The Report also contained an "Addendum" on the question of assigning taxing rights *between* a multitude of places of origin, *viz.* different source states—a question the Experts saw as "becom[ing] of special importance in all business taxation."[144]

This Addendum, which is quite difficult to locate and accordingly has not attracted much scholarly attention, outlines the problems that may arise in the "allocation of earnings where the whole of the economic stages are not conducted in one area."[145] In such a scenario, "different degrees of economic allegiance . . . may attach to different stages of what is in the last resort a single economic action" and continues to see the problem that arises in such circumstances of "how the result of all these stages can be subdivided in order to indicate the different degrees of claim that a State may have upon each operation" when operations are backward or forward integrated across borders. The Addendum sees a need to seek "criteria for assigning the profit to [each] area in which the economic stages have been conducted." Without being explicit—but insinuating/foreshadowing some kind of "arm's length" test—the Report crudely assumes that "criteria of division" could perhaps be more easily arrived at when the operations of one company are identical in two countries. As such, the Addendum was uneasy with cases where no identical operations were carried out in different states and loosely collected

140. *Id.* at 4030.

141. 1923 Academic Experts Report, at 4033–43.

142. *Id.* at 4028.

143. *Id.* at 4027.

144. *Id.* at 4034.

145. *See* the title of the Addendum (*Allocation of Earnings Where the Whole of the Economic Stages Are not Conducted Within One Area*).

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criteria that were generally adopted in practice[146] but stressed that the suitability of these criteria would depend "entirely on the nature of the business" and had to be *ad hoc* taking into account the "actual economic structure of the business under consideration."[147] The Addendum points to the income allocation systems of New York, Massachusetts, and Wisconsin as illustrations. It closes without "any theoretical conclusions as to which are the appropriate criteria for different classes of business." The Academic Experts offer to research the issue in more detail "if it is desired by the Financial Committee of the League"[148]—a desire the League Committee seemingly never developed.

However, what was emphasized was that the process of "production of wealth" was not considered as a mere automatism of owning/assuming assets/risks by the enterprise but to different degrees contingent upon "human agency"—*i.e.*, "people functions" and "controlling power":

> It is not pretended that every function falls easily into one of these four classes [of economic allegiance]. For example, a manager of an estate in Java may be said to be the directing brain living in Java, and some of the legal rights relating to that estate may be enforceable in Java; on the other hand, the final control and direction may be in the hands of directors in Amsterdam; finally, the actual recipient of a part of the profits may be a shareholder in London. *It is not easy in the last analysis to decide whether the production or origin stage can be said to end in Java or whether the brains in Amsterdam are not an essential part of all the operations concerned in production*.[149]

In what might correlate to Professor Knight's agency theory, the Report assumes that part of the origin of wealth is a "human agency" performing functions that are leading to the creation of wealth by "the whole enterprise":

> When we are speaking of the origin of the wealth, we refer naturally to the place where the wealth is produced, that is, to the community the economic life of which makes possible the yield or the acquisition of the wealth. This yield or acquisition is due, however, not only to the particular thing but to the human relations which may help in creating the yield. The human agency may be:
>
> (1) The superintendent or management of the labour and organisation at the *situs*, *e.g.*, the local manager of a tea plantation;

146. The Addendum mentions the value of sales, the total capital employed in a country, the value of real estate in a country, the total salaries and establishment expenses, and the credits arising in one country.

147. *Id.* at 53 [Addendum, p. 1].

148. Addendum p. 2 (1923 Academic Experts Report at 53).

149. 1923 Academic Experts Report at 4027 (emphasis added).

market conditions;"[352] formula apportionment "may in fact present intolerable compliance costs and data requirements;"[353] it would present difficulties "compounded by the existence across taxing jurisdictions of different accounting standards and multiple currencies;"[354] it "would raise questions about the relevance of imposing withholding taxes on cross-border payments between group members and would involve rejection of a number of rules incorporated in bilateral tax treaties."[355]

The Guidelines paid no heed to the theoretical objections to arm's length and the corresponding advantages of fractional methods. And for all the cited objections to formula apportionment, the core objection was the difficulty of achieving international consensus.[356] The Guidelines exhibited a corresponding attitude toward the objections to arm's length generally: although the "arm's length principle is viewed by some as inherently flawed, because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses," there is "no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises."[357] But the difficulty of achieving consensus and the lack of widely accepted objective criteria were and are, at least in principle, remediable circumstances; the Guidelines gave no reason for rejecting out-of-hand an approach that at least began to seek solutions to them.

At the same time, too, the Guidelines did not abandon the skepticism previously expressed by the OECD Task Force about the CPM in its various manifestations, although the Guidelines in the end accepted that method as an acceptable or at least permissible method under the arm's length system. The Guidelines gave the method an entity-specific frame and a different name, the "transactional net margin method," (TNMM) and said that "so-called 'comparable profits methods' or 'modified cost plus/resale price methods' are acceptable only to the extent that they are consistent with these Guidelines."[358] The Guidelines' TNMM expressed a preference for using a comparable that involved the same group (and an uncontrolled counterparty) as the intra-group tested transaction;[359] the U.S. regulations at a minimum express no such preference, and may even be read to *preclude* using a transaction of the same group as the comparable uncontrolled transaction. And the Guidelines emphasized repeatedly that the TNMM was to be used as a last resort, which required observing traditional safeguards

352. *Id.* ¶ 3.67. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.25.
353. *Id.* ¶ 3.69. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.27.
354. *Id.* ¶ 3.70. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.28.
355. 1995 OECD Guidelines ¶ 3.72. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.30.
356. 2010 OECD Guidelines at 36.
357. 1995 OECD Guidelines ¶ 1.9. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.10.
358. *Id.* ¶ 3.1. These provisions are carried forward at 2010 OECD Guidelines ¶ 2.56.
359. *Id.* ¶¶ 3.26, 3.34.

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These ideas were endorsed by a Report which constituted the next step in the evolution of the League's position, the 1925 Report of the Technical Experts.[153]

The Technical Experts, who—based upon actual state practice and the fact of imbalances in payment structures, and possibly their nations being largely creditor nations—favored the classification-and-assignment approach and agreed with the idea of source taxation of business profits posited in their 1925 Report that:

> If the enterprise has its head office in one of the States and in another has a branch, an agency, an establishment, a stable commercial or industrial organisation, or a permanent representative, *each one of the contracting States shall tax that portion of the net income produced in its own territory*. Therefore, the financial authorities of the interested States shall be able to request the taxpayer to hand in general balance-sheets, special balance-sheets and all other relevant documents.
> In the case of shipping enterprises, railway companies, trans-Atlantic cables, aerial navigation companies and electrical power undertakings, the principle of division is applicable, *in proportion to the profits originating in a particular country*, provided that there exists in that country a genuine organisation (office, agency or branch) in which business is actually carried on and that it is not—as in the case of shipping companies, for example—merely a question of vessels calling at ports.[154]

The Academic Experts, all their qualifications notwithstanding, really favored a system based exclusively on residence taxation to enable national tax systems to operate according to the ability-to-pay principle. The Academic Experts suggested that the classification-and-assignment option might be made operable, if it were given priority, by the assignment of taxing rights aligned to Option 2;[155] this suggested that a narrowed application of source taxation was a politically opportune option but not in and by itself inherent in the "classification-and-assignment" approach based on the theory of economic allegiance.

And indeed, theory notwithstanding, the United States had vital political interests in keeping the source taxation American businesses were increasingly facing at a minimum. Because:

> By the end of 1918, the United States had another reason to favor relief for Americans investing American capital be channeled to rebuild post-

153. 1925 Report of First Technical Experts Committee, at 4071.

154. *Id.* at 4091.

155. 1923 Academic Experts Report, at 4055 ("Where method 2 is repugnant owing to a reluctance to abandon the principle of origin, method 4 as modified by method 3 may be the subject of mutual conventions; but even then it is best carried out by an administrative system similar to method 2, supplemented by a collective settlement on agreed lines between the two Governments.").

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> war Europe. The United States was owed eleven billion dollars by allied governments for wartime loans somehow Europe would need access to American dollars to pay off this debt. . . . [Given the contemporaneous reluctances for government involvement,] if Europe was going to get the dollars necessary for the repayment of its debts, the purchase of American exports, and the economic stability necessary for peace, the source would have to be private investment.[156]

One first decisive aspect of keeping source taxation low was to treat subsidiary enterprises not as permanent establishments (PEs)—as a 1927 draft of the Model Convention had done[157]—but as separate taxpayers. The idea of treating subsidiaries as a PE had been employed—as is occasionally done in contemporary times, *e.g.*, under specific circumstances by India[158]—as Mitchell Carroll would later put it—"to reach out to the mother's profits."[159] Economic theory of dependence and control seem to have played no decisive role in the adoption of the rule that subsidiaries should not be treated as PEs, which of course survives into the model conventions to this day.[160]

C. "VALUE CREATION" UNDER ARTICLE 9 OF OECD/UN MODEL TAX CONVENTIONS

1. *The 1933 Carroll Report*

From 1928 through 1933, a subcommittee of the League's Fiscal Committee conducted a study of the problem of the allocation of business profits between associated but separately incorporated enterprises and between home offices and foreign branches.[161] The task of the 1933 Carroll Report[162] was to fill the void left by the 1928 Draft Treaties on the vital

156. Greatz & Hazard, *supra* note 127, at 1051.
157. 1927 Technical Experts Report, at 11 ("The real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, and depots shall be regarded as permanent establishments.").
158. U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, U.N. PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES, Chapter 10.4, U.N. Doc. ST/ESA/347 (2013), http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf; *See* Lee Sheppard, *Revenge Of The Source Countries, Part 6: Subsidiary As PE*, 2006 TNT 200-3 (Oct. 11, 2006).
159. Mitchell Carroll, Taxation of Foreign and National Enterprises—Methods of Allocating Taxable Income, League of Nations Doc. C.425(b).M.217(b).1933.II.A. (1933) [hereinafter 1933 Carroll Report]; *see* Report to the Council on the Work of the Fourth Session of the Committee, League of Nations Doc. No. C.399.M.204.1933.II (1933), *reprinted in* Joint Committee on Internal Revenue Taxation, Legislative History of United States Tax Conventions 4057, at 4242, 4243–47.
160. OECD Model Convention art. 5(5).
161. *See generally* Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, TAX NOTES, Feb. 17, 1986, at 625, 631.
162. Report to the Council on the Work of the Fourth Session of the Committee, League of Nations Doc. No. C.399.M.204.1933.II (1933), *reprinted in* Joint Committee on Internal Revenue Taxation, Legislative History of United States Tax Conventions 4057, at 4242.

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different and almost opposite Proustian *côtés*, blazed in the ensuing decade and a half, which in turn partially set the stage for the differences which became palpable during the BEPS-negotiations.

The first was the course of practice under the regulations/Guidelines, which increasingly fell victim to the main vulnerability of both structures, *viz.*, the tendency of the comparability factors to degenerate into criteria for making allocations directly, and the tendency for the comparability examination to degenerate further into giving primary effect to the contractual terms criterion, rendering a system based very heavily on initial taxpayer determinations. The second path was the evolution of the ideas of the OECD, which increasingly tended, in visible contrast to the direction of practice, to seek ways to de-emphasize taxpayer discretion and control of the allocation process, and at the same time to elevate considerations which could have facilitated an effort to address the kind of conflicts the Guidelines perceived as rendering formulary apportionment unacceptable. This latter evolution was accompanied, paradoxically, by an ongoing pattern of OECD expressions to rule out not only any move toward fractional apportionment, but also to eliminate vestigial fractional methods that the OECD Model Conventions, and their predecessors, had historically retained. Thus, both the conceptual discrepancies and the misleading appearances manifested in the Task Force Reports and the Guidelines of the mid-1990s became ever more exaggerated.

2. *Value Creation and the Hybrid/Schizophrenia of the 1995 Guidelines*

As the hybrid/schizophrenic approach[376] to transfer pricing found entry into the OECD Transfer Pricing Guidelines in 1995, these Guidelines, hence, worked with the idea of "aligning outcomes with value creation" in various degrees but incoherently. Firstly, they start as a general matter being concerned with pricing *transfers of value*, which is not necessarily the same as allocating profits/income to the original/functional value creator. References to the value of contributions to transactions are, therefore, mostly employed as meaning "fair market value"[377] of transferred assets or services rendered, often, but not always,[378] regardless of the actual economic

376. As noted above, we call the system introduced by the White Paper "hybrid/schizophrenic" from the perspective of value creation because it is an odd amalgam based on an implicit acknowledgment that aligning outcomes with firm value creation is inherent in source taxation of business income and establishes methods, esp. the profit split, that assume to capture "relative value" of contributions to firm income. But, it does so based upon market-analogies that screw that very goal by characterizing IP-ownership and risk-bearing as decisive factors.
377. *See* 2010 OECD Guidelines ¶6.27.
378. 2010 OECD Guidelines ¶ 6.38 considers a royalty rate reduction in case where the licencee creates part of the value of an intangible asset. Still, value creation is understood as "cost-bearing."
6.38: "In some cases, a distributor may bear extraordinary marketing expenditures beyond what an independent distributor with similar rights might incur for the benefit of its own distribution activities. An independent distributor in such a case might obtain an additional return from the

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have endorsed applying any hypothetical transfer pricing methods on such a contractual basis,
(iv) created an imprecision/indeterminacy surrounding the arm's length standard in cases were no comparables could be identified (heavily intertwined functions should have been mere cost positions with no income attributed, but costs shared among the group's establishments), *i.e.*, Carroll was hesitant to price transactions on a market basis if there is no actual market;
(v) proliferated the imprecise conceptual dichotomy of arm's length vs. formulary apportionment, *i.e.*, Carroll seems to have misunderstood/overplayed the difference between separate accounting and separate entity ideas, yet, *overall*:
(vi) the report is not a mere "fiscal policy document" in the sense that it would lack any sound theoretical reasoning or address practical administrative concerns. But it created a system somewhat insincere to the fundamental allocation decision inherent in the theoretical concept derived from economic allegiance and over-responsive to the interests of capital exporting countries.[164] But these shortcomings of the report were at their times less dramatic in terms of possibilities for "dislocating" tax bases internationally from their substantial economic source (*i.e.*, for profit shifting), because he did work in a time of less functional integration within groups, less global capital mobility, less (although vital) importance of intangible property, less large residual group returns, and a less pivotal importance of passive factors such as intangibles and risks in allocating the residual within the system Carroll devised. Additionally, the seemingly strict concept of "comparability," the indeterminacy in cases where such strict comparables could not be identified, render the report's suggestion for a transfer pricing system addressing only a narrow class of contemporary cases, and the openness to firm-wide allocations of costs in some instances of economically heavily-intertwined functions, hints at a system embodied in Art. 9 that treats arm's length as a tool for, not the goal of, allocating income.

As to (i). Volume IV of the five-volume Report that develops the allocation system is based on the principles of "origin taxation" of business income as established by the three different 1928 Draft conventions. Carroll reaffirmed that "they all contain the same fundamental criterion regarding income from an industrial or commercial enterprise—namely, that the primary right to tax belongs to the country in which is situated the permanent establishment which produces the income" and that thus "a regime of allocation for business income may be based upon this general proposition regardless of the nature of a country's tax."[165] Hence, the Report describes the "problems in allocating taxable income" in terms of the

164. *See* Vann, *Hard-Boiled WonderWorld*, *supra* note 13, at 321, on Carroll's firm theory "outsourcing approach."
165. 1933 Carroll Report, *supra* note 159, at 172.

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specific value creation settings that industries and industry structures display and give rise to the necessity for differentiations. In structuring his Report Carroll, thus, wrote that:

> [S]ub-classifications must be made of the articles involved, *because the relative importance of sales activities compared with manufacturing differs greatly*. Whereas the profits of enterprises selling automobiles, typewriters and similar articles in which there is keen competition, or branded articles which must be brought to the attention of the public through skillful [sic] advertising, depend, to a great extent, on the sales efforts, other articles, such as scientific instruments, are purchased largely because of their reputation for superior quality gained through years of careful manufacturing. There are practically no two businesses of exactly the same type, size or organisation. Each enterprise reflects the brain and personality of its owner or its principal officers, *and the profits depend largely on their initiative, skill and wisdom. The factors conducing to profits vary with each enterprise*. It is extremely difficult *therefore* to decide on the best methods of sub-classifying industrial and commercial enterprises in order to consider in sufficient detail methods of allocation or apportionment applicable to them.[166]

Moreover, in a description of possible value creating activities a local establishment may perform in the profit generation of the enterprise, Carroll reasons that:

> Sometimes the foreign enterprise maintains, on an important *boulevard*—for example, the Champs-Elysées in Paris, or the Board Walk in Atlantic City—imposing displays of its products in order that they may catch the eye of the transient visitor, who may purchase the product from the local sales branch when he returns to his own home. *In none of these cases just described does the establishment in question make any sales or directly realise any profit. Yet all these activities constitute items of expense, and contribute in one way or another to the realisation of profit somewhere by the enterprise*.[167]
> Continuing to describe the actual profit generation of the enterprise,[168] Carroll assumes that The central accounting of the enterprise should show whether or not, as a whole, the enterprise has realised a profit or loss, and it is probable that every well-run concern maintains accounts for the various units which will enable it to determine whether or not each is a 'paying proposition'. The tax official in each country where there is an establishment has at his immediate disposal only the accounts (if any) of the local establishment, and it is necessary for him

166. *Id.* at 11 (emphasis added).
167. *Id.* at 12 (emphasis added).
168. *See id.* at 11. The use of that term is a bit surprising since Carroll uses it without distinguishing between branches and subsidiaries, indicating that also in case of subsidiaries he sees but one "enterprise."

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allegiance principle.[391] This reaffirmation involved the assumption that the residual profit would be assigned in full to a parent controlling entity on grounds that that entity was responsible to the creation of that value.[392] The principle was adopted as part of the Model Convention system in the 1943 Mexico and 1946 London models, but without any affirmation of the corollary that the residual should be allocated in full to the parent.[393] Instead, those Models contemplated secondary methods of allocation which would have spread the residual throughout the integrated group, but clearly on grounds consistent with the linked ideas of value creation and economic allegiance. And in all events, the early ideas placed little stress on contractual allocations, or on any attempt to define inputs, or functions, to which responsibility for the profit was imputed.

The innovations of the 1962-1995 period interpreted arm's length in ways that deviated more substantially from the underlying idea of economic allegiance. The regulations adopted at the outset of this period rested upon established economic conceptions of substitution at the margin, if not comparable market price could be found, one asked, with respect to some component of the group, what was the marginal price that would entice that component, if independent, to enter the transaction.[394] The problem with this eminently sensible approach was that, if applied serially through one-sided methods to all members of the group, it did not definitively assign the entire group profit. What was left was the residual. The system was agnostic as to the assignment of the residual, in contrast to either of the approaches reflected in the 1933-46 developments: unlike the Carroll Report, the system neither explicitly nor implicitly assumed the residual was created by central management; unlike the London/Mexico Models, the system did not expressly or articulately define "backup" methods which divided the residual among the component enterprises in a manner that at least roughly approximated identifying the locales responsible for its creation.[395]

This system proved unacceptable, because of its indeterminacy: it produced *ad hoc* and inconsistent results, and plainly undermined the corporate income tax base. But the task of reforming it generated both controversy and suspicion. In the end, the United States and the world body, the OECD, formulated a system; the foundation of which was the contractual allocation made by an agreement among commonly controlled corporations—and undoubtedly determined by central management itself.[396]

391. *See* Hubert Hamaekers, *International and Comparative Taxation*, Series on International Taxation, 26 at 30.

392. OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, at 13 (Jul. 10, 2010).

393. *See generally* London/Mexico Models and Commentary.

394. Lorraine Eden, *The Arm's Length Standard in North America*, TAX NOTES INTERNATIONAL 673, 676 (Feb. 2000).

395. *See generally* London/Mexico Models and Commentary.

396. *See* 26 U.S.C. § 482.

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This narrow source concept is expressed in the case of PEs in the preference for the "remuneration of services approach" as the "fairest and most generally practical criterion."[176] Still, Carroll saw a need to justify the residual profit allocation to capital exporting countries this concept entails on *the basis of a theory of the relative economic value of the functional contributions*[177] made by the various parts of the enterprise to the firm's value creation. Carroll wrote that:

> If we recognise the fact that the real centre of management, especially if it is situated at the principal productive establishment, is the most vital part of the enterprise, the most practical approach to the problem is to give it the residuum of profit or loss after allocating to each outlying secondary establishment compensation for the services it has rendered to the enterprise in accordance with what would be paid to an independent enterprise rendering such services.[178]

Carroll, arguing in favor of the "remuneration for services" method, weighs the restricted profit allocation that entails for source countries with practical considerations:

> The country of processing or sale may find it advantageous, because it receives, as a basis for its tax, remuneration for the services rendered regardless of whether the enterprise as a whole realises a loss. On the contrary, *either country may consider its tax basis as being arbitrarily restricted, especially if the enterprise realises a large profit, which, if apportioned, would throw to each country a larger tax basis than that of the fee or commission charged. This objection may be outweighed by the practical advantage of not having to ascertain what part of the net income from joint activities is attributable to the local establishment*, as well as that of collecting a tax on the commission (percentage of gross receipts) or fee even when the enterprise itself realises no net income. The enterprise has the advantage of knowing definitely that it will be taxed on the same amount it would pay to an independent enterprise for rendering it the same services, and of not having to submit the head-office accounts in order to effect an allocation of net income.[179]

As to (iii). Because Carroll saw his task as "formulation of a *scientific regime of allocation*,"[180] the justification for the narrow concept of source allocation could not be portrayed as mere political expedience or necessity in avoiding/minimizing the risk of double taxation. The narrow source concept was, thus, additionally justified through a legalistic view on the creation of income and value creation, which the Report deducts from the "nature of

176. *Id.* at 192.
177. *See Vann Hard-Boiled WonderWorld*, *supra* note 13, at 325, for critique of Carroll view on firm valuation creation.
178. *Id.* at 192.
179. *Id.* at 168.
180. *Id.* at 198.

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income taxation" in general and the "separate accounting approach" in particular. *Firstly*, the Report argues that "[i]n economic fact, no profit accrues to the enterprise consisting of the producing corporation and the selling corporation, until the goods have been sold by the selling corporation to outsiders,"[181] but that "economic fact must inevitably give way to the definite principles and provisions of law under which business is conducted."[182] *Secondly*, with regard to the income allocation to subsidiaries, a question Carroll treated as generally to be handled in the same way as income allocation to permanent establishments but taking their specific differences into account, the Report assumes that the "fundamental legal difference" between the two is that subsidiaries *can enter into legally binding contracts with other "component parts."*[183]

On this basis, the Report airily concludes that

> As the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments of an enterprise but treated as independent legal entities; and if it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise.[184]

The allocation regime Carroll, thus, seemingly infers from the possibility of concluding legally binding contracts that the functions the entities perform are separable enough to reliably price them completely independently by using market comparables. In other words, contracts to Carroll seem to have been more of an expression of separable functions than the contract in and by itself being the actual reason to analyze and price the functions separately. Additionally, that no comparables could be found for such separated functions was a scenario Carroll assumed did and would rarely occur.[185]

As to (iv). Therefore, evidently, less clear was the solution to the allocation problem especially when (i) no comparables could be found *in the subsidiary case*, and (ii) *in the PE case*, functions were heavily intertwined with the effect that "the income of an establishment becomes dependent upon the outcome of its relations with other establishments or subsidiaries of the enterprise."[186] This is a situation we today call integrated value-chains, or as the Carroll Reports describe it, interactions between "*establishments which create, add value to, or sell a product, the profit or loss of each of which awaits the*

181. *Id.* at 176.
182. *Id.* at 177.
183. *Id.* at 176.
184. *Id.* at 177.
185. *See id.* at 191 (in context of profit allocations to PEs).
186. *Id.* at 178.

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eventual sale and depends to a greater or less degree upon the efficiency of the other establishments involved."[187] While the first question remained completely unanswered,[188] the Report addresses the latter question displaying its logic[189] and finding solutions that show remarkably that Carroll was much more inclined to perceive the joint value creation of firms as decisive in allocating profits globally.[190] This may be exemplified with regard to R&D functions:

> When income is derived from the purchase of goods in one country and their sale in another, or from the production, processing or manufacture of goods in one country and their sale in another, the theories under different systems of law conflict as to whether the place of sale is the exclusive source of income or whether the other country in which the goods have been bought or produced *or their value increased is likewise to be considered as a source and, if so, how much of the total income derived from the transaction should be ascribed to each*. The problem is complicated further when an enterprise has establishments which do not produce or sell goods, but which contribute indirectly to the creation or sale thereof—*for example, research establishments, statistical bureaux and display rooms. Moreover, no income may be actually received or realised at the real centre of management, yet the financial management, the determination of policies and possibly the technical management are carried out there, and have a direct influence on the realisation of profits at the various establishments*.[191]
>
> * * * *
>
> *Research and Statistical Bureaux, Display Rooms, etc.*—Large enterprises often maintain establishments which do not produce, add value to, or sell goods, or sell services and therefore contribute only indirectly to the realisation of profits. For example, an enterprise may maintain a

187. *Id.* at 178 (emphasis added).

188. *See* Stanley S. Surrey, *Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions*, 10 LAW & POL'Y INT'L BUS. 409, 460 (1978).

189. Carroll poses questions that display how close to the idea of installing a "source" tax geared to economic "value creation." He approached this by stating that:

> In this connection, it is necessary to consider, inter alia, (a) where and when the income actually arises or accrues to the enterprise as a whole; (b) which types of establishments should be considered as productive of such income; (c) how is the expense of the unproductive establishments to be absorbed; (d) if a productive establishment in one country transfers goods to an establishment in another country, should a taxable profit be said. to accrue to the first establishment, regardless of whether the enterprise subsequently realises a loss; (e) should the net profit of one establishment be set off against the net loss of the enterprise, and vice versa; and (f) how is the profit of each establishment to be determined?

1933 Carroll Report, *supra* note 159, at 79.

190. The hierarchy of methods for business functions that warrant a "separate remuneration" but are not solvable by reference to "uncontrolled prices" are described in the discussion of the 1943/46 Drafts below. *See* ¶ II-C-2 *infra*.

191. *Id.* at 178-79.

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research establishment which develops new inventions or processes or methods of production, which some day may or may not be used. They work exclusively for the enterprise, and in themselves represent only expense to the enterprise. The invention perfected in a given year may represent years of effort, and more years may elapse before the article is placed on the market, or the machine is installed in the factory, or the process introduced. *The value of the machine or the process, if successful, may be difficult to measure in terms of income.* It may prove valueless and be scrapped almost at once. If the new invention sells, the results are reflected at the sales establishments. *It hardly seems feasible to ascribe any profit to a research establishment, but its cost should be included in overhead and distributed in some appropriate manner.* If a research establishment renders services to outsiders for which it receives compensation, such income should of course be taxable in the country of such establishment.

What has been said of research establishments applies equally well to offices that are sometimes installed in a central city for the purpose of gathering statistics on the production or consumption of competing articles, or probable sales in the local or neighbouring markets. Obviously such an establishment is in itself only an item of expense, and its services can hardly be evaluated in terms of income. If its services are effectual, the results are shown at the sales establishments of the enterprise. Sometimes manufacturers of automobiles, aeroplanes or other products maintain displays on well-known avenues or at much-frequented resorts, which merely display the products and possibly distribute literature concerning them, but do not affect any sales or take any orders. The interested passer-by either purchases from some local sales establishment or at the selling establishment in his own country. Such an establishment should therefore be regarded as only an item of expense, and no profit should be ascribed to it. The effectiveness of the display will be reflected in the sales within the same country or in the other countries in which the traveller purchases the product. For all such establishments, *the rule should be that in principle no profit will be ascribed to them but that their expense shall be included in the general overhead of the enterprise which is apportionable in some appropriate manner. It is argued by some administrations that the same compensation should be ascribed to such establishments as would be paid to an independent enterprise rendering similar services. Such establishments are so closely tied up with the enterprise, however, that it would be almost impossible to find an independent enterprise which would serve as a basis of comparison. No exception to the general rule should therefore be made, unless the establishment actually renders services to outsiders for which compensation is received, or renders services to the enterprise which have a determinable money value.*[192]

192. *Id.* at 181-81.

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As to (v). As a general matter of concern, the Carroll Report introduces into the global discourse the dichotomy between the "two underlying theories of taxing foreign enterprises" that he saw.[193] On the one hand, there was the theory that "the local establishments should be taxed on the basis of separate accounts and treated *in so far as possible* as if they were independent enterprises."[194] On the other hand, there was the idea that "the enterprise is an organic unity and, consequently, the tax should be assessed on that part of the enterprise's total net income (computed in accordance with the law of the taxing country) *which corresponds to the relative economic importance of the local establishment*."[195] While on the surface only "fractional apportionment" was geared to capture the internal value of functions performed, the hierarchy of possible transfer pricing methods implicit in the separate accounting method (which found its way into the 1943/46 London/ Mexico Models) in effect ensured that outcomes could not be completely divorced from the economic value of the contributions to the firm.

As to (vi). In addition to that, and lastly, in arguing against fractional apportionment, Carroll raised some convincing arguments but overlooked or withheld that they were not equally convincing when employed to justify his narrow view on separate accounting:

> When the problem of taxing a foreign enterprise is viewed from the general principle that a State has jurisdiction *only over persons within, property situated within, or transactions effected within its territory*, it is obvious that, if the taxpayer resides in a foreign country, the State's jurisdiction over its income should be restricted to income from property or other source within its territory. The principle of permitting only the country of fiscal domicile *to tax the total net income of the taxpayer* is so generally *accepted* that it would appear inconsistent to incorporate in the regime a provision permitting any country in which the enterprise has a branch establishment to take jurisdiction over the total net income in order to determine what part thereof might be attributable to the local establishment.[196]

Carroll slightly theatrically added:

> Various Governments which apply the method of fractional apportionment maintain that the total net income shall be computed in accordance with their own legislation, even though only a very small part thereof may be attributed to the local branch. This involves not only determining gross income from sources in one or more foreign countries, but also allowances for business expenses, bad debts, depreciation, losses and other allowable deductions. Assuming that the administration in question endeavored to make as accurate a

193. *Id.* at 187.
194. *Id.* (emphasis added).
195. *Id.* (emphasis added).
196. *Id.* at 187-88 (emphasis added).

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assets in the absence of circumstances in a particular case that warrant a different view;"[426]

- For intangible assets, "[t]he significant people functions . . . are those which require active decision-making with regard to the taking on and management of individual risk and portfolios of risks associated with the development of intangible property,"[427] and "the key question in determining economic ownership of acquired intangibles is where within the enterprise the significant people functions related to active decision-making relating to the taking on and management of risks are undertaken."[428]

The first question one might ask about "people functions" is, perhaps, which is determinative, the "people" or the "function." For instance, suppose that the home office is in New York and the PE is in Frankfurt. The senior manager of the PE makes a decision to acquire intangible property, but does so while working at the home office in New York. Is the asset then attributable to the home office or the PE? Suppose the decision is made while s/he is in a third place, whether during the course of the officer's employment, or perhaps while s/he is on vacation?

Presumably the part of the enterprise with which the "people" are associated would be the decisive consideration, at least in these circumstances. This gives rise to a second question, of how one associates "people" with parts of the enterprise. Personnel may be no more definitively associated with any given part of the enterprise than are assets, activities, functions, or risks. A third question concerns "decisions" or "management" which involve a number of persons, or perhaps a formal committee or board consisting of persons associated with the PE as well as others associated with the home office (and perhaps still others associated with another PE). It should be apparent that even this concept of "people functions" may frequently require the same sort of allocations as are required by assets, costs, income, or other concepts—and that the AOA Report does not give definitive or clear answers to questions posed by the need to make such allocations.[429]

Also in relation to "risk" and the attribution of risk, the AOA ventures into somewhat new territory, but in doing so it devises notions that will influence its later work, in particular under BEPS Actions eight through ten.[430] Its cardinal principle is that a PE should be considered as assuming any risks 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.[431] It gives the example that "the PE should, generally, be treated as assuming the risks arising from negligence of employees engaged in the function performed by

426. *Id.* ¶ 15.
427. *Id.* ¶ 116.
428. *Id.* ¶ 125.
429. *See id.* ¶¶ 30–36.
430. *See id.*
431. *See supra* note 413, ¶¶ 30–36.

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2. *Synthesis of Diverging Approaches: The 1943/46 Model Treaties*

As noted, the 1935 multilateral convention drafted by Carroll was never formally adopted,[203] but its provisions became part of the 1943 Mexico and 1946 London Model Conventions,[204] the intermediate precursors to the modern UN and OECD Models, respectively.[205] The 1940s Models, on the one hand, reconfirm the basic idea that actual economic contributions to the "production of income" by the enterprise ("value creation") is the reason and justification for taxing international business profits at source. The adherence to the idea of economic allegiance which is implicit in the classification and assignment approach is expressed best in the discussion of whether purchasing establishments should be recognized as PEs and, thus, give rise to sharing in the profits of the enterprise of which the activity is part. The Model Commentary pertaining to the Conventions reasons that:

> From a general point of view, it is sometimes argued that, when goods are bought in a country, the profits should be divided between the two functions of purchase and sale just as they are divided between manufacture and sale. It is added that to exempt purchasing establishments of foreign enterprises would constitute a discrimination against domestic exporters. On the other hand, it has been pointed out that the act of purchasing in itself yields no profits. *Indeed, unlike producing, converting, processing, manufacturing, sorting, preserving, assembling, packing and transporting, a purchase adds no value to the thing bought. Consequently, it seems that the taxation of a so called purchasing profit by the country where the purchasing establishment is situated*, except perhaps when income is attributed to a purchasing establishment on a commission basis—*i.e.*, as if that establishment were an independent agent working for a foreign firm—*would give an extraterritorial scope to its income tax*.[206]

On the other hand, while both model treaties set out a scheme said to be ultimately aimed at "a fair allocation of income"[207] of PEs, they are principally based upon the fundamental procedure[208] of separate accounting, and expressly embrace a rather narrow concept of source taxation of business profits. Nonetheless, neither Model Convention excluded hypothetical, (unlimited or limited) formulaic methods and unspecified approaches as

203. *See Vann Hard-Boiled WonderWorld* at 322, arguing that "the reason is likely to have been debate over whether Carroll's outsourcing approach was correct."
204. *See Carroll*, *supra* note 159, at 558, 561, 563.
205. *Id.* at. 558, 561.
206. League of Nations, London and Mexico Model Tax Conventions—Commentary and Text, League of Nations Document C.88.M.88.1946.11.A. (November 1946), reprinted in Conventions Legislative History, at 4319-4437, at 15 (4335) [hereinafter London/Mexico Models and Commentary].
207. *See* London/Mexican Models and Commentary at 82 (4402), 83 (4403) [Conventions Protocol Art. VI, ¶ 5].
208. *See* London/Mexico Models and Commentary at 18 (4338).

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secondary methods for all transactions *if separate accounting was infeasible or did "not result in a fair allocation of income," and installed apportionment as the primary method for "items of expenses that must necessarily be apportioned."*[209] As is the case with the Carroll Report, these Model Conventions did not specify how profit shall be allocated between associated enterprises—possibly assuming that the contractual basis of the transactions will allow for a comparability analysis and *thus* application of a one-sided method—but treat the question of profit attribution to PEs as relatively extensive, and relatively pragmatic.

The allocation scheme rested in a first step on the exclusion of subsidiary enterprises from the PE-definition, a concept which had already prevailed since the 1928 Draft Convention. The purpose of excluding subsidiaries from the PE-definition (art. V para. 8 of respective Protocol[210]) was said to be (i) to negate entitlement of the state where the subsidiary is situated "to tax the parent company" except on dividends it may receive; and (ii) to bar the country where the parent is located from taking into account "the actual profits made by the subsidiary."[211] While this exclusion may be seen as failure to internationalize the German *Filialtheorie*,[212] the commentary makes no reference to any economic theory but references only the legal separateness as causal "therefore"[213] for the separate taxation. The system for verifying "the correctness of the mutual relations between the parent and the subsidiary companies" was indicated in art. VII of the protocol to the 1943/1946 Conventions,[214] was taken almost verbatim from art. V of the 1935 Draft Convention.[215] With regard to the profits to be attributed to permanent establishments, art. IV and art. VI of the Protocol established a system that was devised to ascertain that source state taxation "cannot exceed the earnings that are the direct result of the activities of the establishment concerned or the yield of the assets pertaining to it."[216]

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209. *See* London/Mexico Models and Commentary at 21 (4341).

210. The fact that a parent company, the fiscal domicile of which is one of the contracting States, has a subsidiary in the other State does not mean that the parent company has a permanent establishment in that State, regardless of the fiscal obligations of the subsidiary toward the State in which it is situated.
London/Mexico Models and Commentary at 76 (4396), 77 (4397) [Conventions Protocol Art. V, ¶ 8].

211. London/Mexico Models and Commentary at 17 (4337).

212. *See* Jens Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law*, (2010).

213. London/Mexico Models and Commentary at 17 (4337).

214. *See* London/Mexico Models and Commentary at 82 (4402), 83 (4403) [Conventions Protocol Art. VII].

215. Fiscal Committee—Report to the Council on the Work of the Committee—Fourth Session, League of Nations Document No. C.399.M.204.1933.II (June 26, 1933) at 2, 3-7, *reprinted in* Conventions Legislative History, at 4245 [Draft Conventions ¶ 5]. Conditions that would have "been made" between independent enterprises (1935) was changed to conditions that would have so "existed" (1943/46). The full text of the Protocol article is quoted at note 171 *infra*.

216. London/Mexico Models and Commentary at 4337-38.

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The method of "separate accounting" was understood to have the "intended result that each establishment or branch is taxed as if it constituted a distinct independent enterprise and the profits of the establishment are assessed independently of the results of the business done elsewhere by the enterprise to which it belongs." Thereby, the model commentary is explicit on the purposes the use of the "separate accounting" method as the "fundamental procedure" should serve. It states that:

> [F]irst, by treating a branch establishment not as part of an enterprise but as a self-contained unit and thus generally avoiding reference to results or data outside the country concerned, *it gives the taxation of branch establishments a strictly territorial scope not extending beyond the boundaries of the countries concerned*; secondly, the method helps to enforce the principle of equality of treatment of foreigners by placing, in principle, branches of foreign enterprises on the same footing as similar establishments of domestic enterprises as regards the computation of receipts and expenses, which, once they have been allocated or apportioned by separate accounting, are to be treated in accordance with the tax laws of the country to which they have been attributed; thirdly, the use of separate accounting as a basis for the assessment of income tax conforms to the usual practice among concerns engaged in international business of keeping separate accounts for each of their establishments; finally, separate accounting serves the revenue interests of the country concerned, because, when it is properly applied and supervised, it prevents the concealment of profits or their diversion from one country to another.[217]

The Protocol to both Conventions contained a hierarchy of methods to make the "separate accounting" procedure operable. The primary method was to attribute to each PE the "net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions."[218] Such net income, in principle, should have been determined on the basis of the separate accounts pertaining to such establishment (Art. VI para. 1, lit. A of respective Protocols).[219] The commentary did not specify if that method was—in terms of the Carroll Report—to be a "remuneration for services" or a "sale between independents" like approach or both and, if so, in which order. "If an establishment did not produce an accounting showing its own operations, or if the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or *if the rectifications provided for in the preceding section cannot be effected*, or if the taxpayer agrees, the fiscal authorities may determine, in a presumptive manner, the business income by applying a percentage to the gross receipts

217. *Id.* at 4338–39 (emphasis added).
218. *Id.* at 4338.
219. *Id.* at 4398.

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of that establishment."[220] This percentage was to be fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country (Art. VI ¶ 1, lit. C of respective Protocol).[221]

This meant that in cases where uncontrolled prices could not be determined, the application of "separate accounting," in a narrow sense, collapsed. "If the methods of determination described in the preceding sections are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated" (Art. VI para. 1, lit. D of respective Protocol).[222] This was considered typical for situations in which functions were economically integrated and, thus, incomparable to market transactions that a "comparison with the results obtained by similar enterprises operating in that country" was not possible. With regard to the apportionment the commentary, exposing its "value creation" foundation, specified that:

> [A] situation [where apportionment of income will be necessary] arises when a comparison between the nature of the activities and the conditions of operation of the establishment of the foreign enterprise cannot be made with those of full- fledged domestic enterprises. It is provided that, in this case, the method of fractional apportionment may be applied. Under this method, the earnings of each establishment are computed as a proportion of the entire profits of the enterprise to which the establishment belongs, on the basis of the general balance sheet and profit-and-loss account of the enterprise. Such fractional apportionment may be unlimited or limited. In the first case, it takes as its starting-point the total income derived by the enterprise as a whole from all sources. In the second case, reference is made only to that part of the total profits of the enterprise which is derived from transactions in which a part has been taken by the establishment whose share in the total profits is to be determined. It is to this second form of fractional apportionment that recourse may be had according to the Protocol. The share of the total profits from joint transactions that is attributable to the establishment concerned is to be determined by dividing these profits according to the ratio that exists between certain factors pertaining to the establishment concerned and the total of the same factors for the entire enterprise.[223]

Furthermore, in cases where the foregoing rules—*i.e.*, including (limited or unlimited) fractional apportionment—did not result in a "fair allocation" of income, the competent authorities could even consult to agree upon any

220. *Id.*
221. London/Mexico Models *supra* note 206, at 4398.
222. *Id.*
223. *Id.* at 4340.

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method that will prevent double taxation (Art. VI para. 5 of respective Protocol).[224]

Less clear was the allocation "procedure" in cases of legally-separate but controlled-subsidiary enterprises, apart from their separate taxation. Article VII of the Protocol to both Conventions—like their successor-norm Article 9 of the OECD and UN Model Tax Conventions—stated without further explanation[225] that:

> When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the laws of the State of such enterprise.[226]

Overall, the combined Commentary to the 1943 Mexico and the 1946 London Model Conventions—which became the blue-print for the OECD's Model of 1963—displays the synthesis of the diverging approaches, taxation at the "origin" of business income according to the internal relevance in "value creation," and a scheme to make this idea operative that is based on a narrow "source" concept that gives primacy to a "production cost" logic of income allocation. But unlike later efforts, this system did not assume "separate accounting" as the sole applicable method, but had a potentially wide scope of application when CUPs or comparable "gross receipts" were not identifiable or simply did "not result in a fair allocation of income."[227] Most importantly, when a comparison between the "nature of the activities and the conditions of operation of the establishment of the foreign enterprise cannot be made with those of full-fledged domestic enterprises" was not possible, the Commentary to both Conventions saw limited (*i.e.*, transactional profit splits) or unlimited fractional apportionment as appropriate methods.[228] This methodology, although very elastic and dependent upon the standards of "comparison" and how the "nature of

224. *Id.* at 4402.
225. Notoriously, the early OECD Commentaries found this Article so "evidently appropriate" that it "seems to call for very little comment;" *cf.* 1963 Commentary at 93, and 1977 Commentary at 88. Contrary to that, the German Federal Government in 1987 still saw "the consensus on the actual application of the 'arm's length principle' [as] extremely vague and precarious,"
cf. Reservation to the OECD Thin Capitalisation Report (1987), 36, fn. 2.
226. *See* London/Mexico Models and Commentary, at 4402–03 [Conventions Protocol Art. VII].
227. *Id.*
228. *Id.* at 4340.

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activities" would be interpreted, as well as the fallback methodology for a "fair allocation," gave the origin/output logic of business taxation potentially the most direct expression at any point in the evolution of transfer pricing standards. And it is important to emphasize that the provisions of the London/Mexico Models, the accompanying Protocols, and the Commentary all received official League sanction and found their way into enforced bilateral conventions in the ensuing era; in contrast to the Carroll Report, which, with its narrow conception of source and near idiosyncratic theory of value creation, was already a merely advisory document.

Efforts to decrease the weight of this origin/output logic is also potentially inherent in the system underlying the wording of Art. VII of the Protocol that later became Article 9 of the OECD and UN Models. Through interpreting the treaty article as demanding the application of the "one-sided" methods that do not need close actual comparables and that create unallocated residual returns, started to emerge in the United States in the 1960s when the application of the primary CUP method increasingly collapsed amidst changed economic and geopolitical circumstances.

III. Background and Validity of the Paradigm: The Era of the United States Regulations (1962-1995)

A. The United States Regulations of the 1960s

Through the end of World War II, the principles of an international tax "order," including the conceptions of transfer pricing, originated with the League. After the war, as the London/Mexico Models signaled, the work would proceed down two diverging roads taken by different international organisations. Conventions among European "developed" countries would be the work of a new organisation, the Organisation for European Economic Co-operation (OEEC); those between developed and developing countries of the United Nations (UN).[229]

But in the postwar period, the international economy was undergoing substantial change, the most salient feature of which was the dominant role of the United States, which at the end of the war accounted for as much as 40 percent of the world gross domestic product. A signal feature of this period was the international expansion of the TNE, particularly those based in the United States. In previous times, most international expansion by integrated groups involved backward vertical integration, principally involving natural resource industries; the home country would own suppliers involved in extractive or agricultural activities, principally in smaller, less developed nations. The new American TNE, by contrast, involved forward integration and often horizontal integration. The companies established markets in foreign locations, and instead of exporting through local distributors, would establish their own controlled distribution operations in

229. *See generally* Mitchell B. Carroll, *International Tax Law: Benefits for American Investors and Enterprises Abroad*, 4 Int'l L. 558 (1971).

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separately or locally incorporated bodies; and often they would establish full-fledged production operations, ordinarily separately incorporated, in the foreign markets.

Under such circumstances, the OEEC expanded in 1961 to include the developed economies of North America (Canada and the United States) and the Pacific region (Japan, Australia, and New Zealand), and became the OECD. The OECD revised the London Model, the first revision of the postwar-era, in 1963. But as to the transfer pricing matter, the significant work of the 1960s was unilaterally accomplished by the United States. The manner in which the innovations of the period interact with the fundamental principles descended from the 1920s—question of residence based taxation, source based taxation, and "classification and assignment"—are best understood in the context of more general economic difficulties confronted by the United States during this period. These problems, and the policy responses to them, were in important senses unique.

The immediate postwar period outside the United States was characterized by circumstances that frequently posed serious threats to private capital investment: the European colonial empires were in the process of being dismantled, leading to the independence and emergence of new nations; the Soviet Union, encouraged by the Yalta Conference, imposed socialist systems on its Eastern European neighbors, and socialist or communist movements took power in numerous places in this emerging world, most notably in China; and postwar devastation throughout Europe and Asia made capital formation difficult. In these circumstances, the United States became a beacon, or haven, of free enterprise stability, and foreign investors had substantial incentive to invest in the United States. At the same time, United States enterprise found substantial opportunity for investing in active business outside the United States. The result was that the United States became a substantial *importer* of "portfolio" investment capital,[230] and a great *exporter* of "direct" investment capital. But the export amounts consistently exceeded the import amounts, so that the United States was a net capital exporter.

Beginning in the mid-1950s, the United States began running a balance of trade deficit, importing more goods and services than it exported. This condition has since persisted for the six-plus decades. Ordinarily, a nation in a net-import trade position is also in a net-import capital position: borrowing is necessary to sustain the trade deficit. But, the United States was in the unusual position of running a balance of trade deficit concurrently with running a surplus in its capital account. These circumstances were made possible only because the dollar had become an international reserve currency, which gave the United States what Charles de Gaulle would call the "exorbitant privilege" of importing while still investing abroad in a period of fixed exchange rates. Notwithstanding this privilege, however, the

230. *See Hearings Before the House Comm. on Ways and Means*, 90th Cong. 79–81, 84–86, 93–94 (1964) (testimony of Douglas Dillon, Secretary of the Treasury).

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United States' balance of payment deficits steadily grew, and, despite the international standing of the dollar, led to a drain on the gold reserves, which by the mid-1960s became quite threatening.[231]

Prior to this development, United States administrations viewed the expansion of United States TNEs as a positive development from the standpoint of United States foreign policy.[232] The Eisenhower Administration had, in keeping with this policy, advocated to reduce the rate of tax on the foreign earnings of the United States TNEs. When the Kennedy Administration came to power in 1961, it had quite different views, in part because it held "center-left" viewpoints more sympathetic to labor, and partly because of the increasing seriousness of the balance of payments problem. The balance of payments problem could have been mitigated by allowing domestic interest rates to rise in relation to foreign (primarily European) interest rates. The Administration opposed such an approach because rising rates could impede domestic growth and employment.[233] The administration was, thus, committed to keep domestic interest rates low in relation to foreign rates—and the rates in question were *after-tax* rates. The corresponding tax policy would be to *tighten* or raise the taxation of the foreign income of United States persons (exported capital), and to *relieve* or lower the taxation of the United States income of foreign persons (imported capital). This is what the administration-sponsored legislation of the period did: the Revenue Act of 1962[234] enacted the "controlled foreign corporation" provisions and its legislative history mandated revision of the transfer pricing rules; the Foreign Investors Tax Act of 1966[235] eliminated most of the "force of attraction" aspects of the taxation of foreign-owned United States businesses and reduced United States taxation of "inbound" investment.[236] And this policy, translated into theory, exhibited an emphasis on *residence* basis taxation generally, and de-emphasis of *source* basis taxation, as a general matter (whether with respect to passive or active income).

The Johnson Administration proposed its new transfer pricing regulations in 1965[237] and 1966,[238] and finalized them in 1968[239] and 1969.[240] The

231. *See id.* 79 – 81.

232. *See generally* Robert Gilpin, U.S. POWER AND THE MULTINATIONAL CORPORATION: THE POLITICAL ECONOMY OF FOREIGN DIRECT INVESTMENT, 115 (1975).

233. *See, e.g.*, President's Special Message on the Balance of Payments I (July 18, 1963), *reprinted in House Comm. on Ways and Means, Legislative History of H.R. 8000*, 88th Cong. (1966), quoted at Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, TAX NOTES, 625, 644 n.183 (1986).

234. *See generally* Pub. L. No. 87-834, 76 Stat. 960 (1962).

235. *See generally* Pub. L. No. 89-809, 80 Stat. 1555 (1966).

236. In this period of the ascendancy of "Keynesian" economics, the Administration's solution to the balance of payments problem was through direct capital controls. The Congress enacted the Interest Equalization Tax Act of 1964 to limit outflows of portfolio capital, and later, the Johnson Administration imposed controls of foreign direct investment in 1968.

237. Allocation of Income and Deductions Among Taxpayers, 30 Fed. Reg. 4256 (proposed Apr. 1, 1965).

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regulations were a radical departure from prior practice in a number of respects.

First, the Carroll Report and the London/Mexico commentary seemed to contemplate using "comparable" prices in circumstances where there was an actual, tangible transaction, usually of an "intermediate" or semi-finished good, between components of an integrated enterprise in different countries.[241] For instance, a company extracting crude oil in an oil-producing country might be selling the crude to its parent in a developed country, or an integrated petroleum company might sell refined product to an entity where petroleum products are marketed either to be further refined into gasoline or sold at retail. The new regulations went further and required the "construction" of transactions among the enterprises where no actual transaction took place.[242] Thus, if a soft drink company were selling a product to a bottling subsidiary, the transaction was not just the sale of syrup, but also might entail a "license" of the formula for the product, and possibly also a licensing of a trademark associated with the product. This was not contemplated in the materials generated by the League.

Second, the regulations had separate rules for five categories of transactions—loans, provision of services, leasing of tangible property, licensing and transfer of intangible property, and transfers of tangible property—which were novel categories, not mentioned as such in the work of the League or prior documentation.[243]

Third, and most important, the regulations introduced a determinate hierarchy of "methods" for "pricing" transfers of tangible property within what, until then, had been the uniform yet rather vague category of "separate accounting."[244] These were the comparable uncontrolled, resale price, and cost-plus methods. They were to be used in that order, and if

238. Allocation of Income and Deductions Among Taxpayers; Determination of Sources of Income, 31 Fed. Reg. 10394 (proposed Aug. 2, 1966).

239. Allocation of Income and Deductions Among Taxpayers, 33 Fed. Reg. 5848 (Proposed Apr. 16, 1968).

240. Allocation of Income and Deductions Among Taxpayers, 34 Fed. Reg 933 (proposed Jan. 22, 1969).

241. 1933 Carroll Report, at 177, 191–92.

242. 33 Fed. Reg. 5848.

243. The 1933 Carroll Report's discussion of the appropriate "methods of allocation" was structured along broader functional categories of the entities under review and industry sectors; these were: Industrial and Mercantile Enterprises (Selling Establishments, Local Establishments selling abroad, Producing Establishments, Processing Establishments, Assembly Plants, Buying Establishments, Establishments buying and processing, Research and Statistical Bureaux, Display Rooms, etc., Warehouses, Real Centre of Management); Banking and Financial Enterprises; Insurance Enterprises; Transport Enterprises; Power, Light and Gas Enterprises; Telegraph, Telephone, Radio and Cable Enterprises; Mining and Agricultural Enterprises; Other Kinds of Enterprises. *See* 1933 Carroll Report, Vol. IV, Chapter XII, 177–78.

244. The 1933 Carroll Report contained some rather disorderly deliberations on "methods of allocation" pertaining to the categories he structured whereby Carroll mashed up the functional analysis and the application of the transfer pricing methods he labeled as effecting "separate accounting." *See* 1933 Carroll Report, Vol. IV, Chapter XII, 187–90.

they all failed, a fourth, unspecified "other" methods could be used. The second and third of these methods, resale price and cost-plus, were what would come to be called "unilateral" or "one-sided" methods (or "single-component" methods) because they were based on examining data from only one component of the integrated group.

These methods, though they had no explicit antecedents in the League work, had a certain primitive logic behind them. One first looked for "comparable" uncontrolled prices. If these could be found, one used them, as they could with, for instance, readily traded commodities: if an integrated oil company was paying a producing arm a price in excess of readily determinable prevailing market prices for crude, the parent was "shifting" profits to the producing company, and an adjustment should be made. Under the new regulations, if such prices could not be found, one should look severally at the various components and ask: "What is the marginal price that would induce this party, if it were a separate enterprise, to enter the transaction?"[245] This the new methods essayed to do.

These new methods, however, created the basis for concentrating the residual profit in a single component of the enterprise at will. If the "one-sided" method allocated only a "marginal" profit to the component which was examined (the buyer-reseller in the case of resale price, the intra-group seller in the case of cost plus), then the residual would principally be allocated to the *other party* of the intra-group transaction. The 1960s regulations, thus, created occasion for the concentration of the residual in one other important respect, which prefigured the difficulties encountered in this century at the heart of the "negative" justification for the "value creation." With respect to intangible property developed by a group, the regulations provided that the cost-bearing member of the group would be deemed to be the "developer" of the property, and other members participating in the development, and acquiring an interest in the intangible on account of that participation, would be treated as routine "assisters." The regulations provided that "no allocation with respect to such development activity shall be made . . . until such time as any property developed, or any interest therein, is transferred, sold, assigned, loaned or otherwise made available in any manner by the developer to a related entity in a transfer" subject to the regulations.[246]

Accompanying this concept was a provision of the regulations providing for "cost sharing" agreements which effectively means sharing the "developer" functions and consequently the tax transfer pricing "ownership" of any resulting intangibles. A cost sharing agreement was defined as a written agreement among the members of the group to share the "costs and risks" of developing intangible property "in return for a specified interest in any intangible property to be produced."[247] If the costs and risks were

245. 33 Fed. Reg. 5848.
246. Treas. Reg. § 1.482-2A(d)(1)(ii).
247. Treas. Reg. § 1.482-2A(d)(4).

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shared on an "arm's length basis," there was to be no adjustment to reflect the transfer of any interest to any member of the group (and no single party was deemed to be the "developer" or "reseller"). The proposed regulations issued in 1966 set forth articulate provisions governing such arrangements, focused upon the manner in which "costs and risks" were to be shared.[248] The final regulations eliminated most of these specific provisions, but retained the provision permitting taxpayers to enter such agreements.

The approach of the regulations, though as noted reflected a primitive logic, nevertheless represented a meaningful departure from the Carroll Report and from prior treatments of the subject with respect to "residual" profits. In the 1930s and 1940s, the contemplation was that the residual profits would necessarily, if not automatically, be assigned to the "parent" enterprise, on the theory that those profits were in some sense "produced" by central corporate management. In the 1960s regulations, this was no longer the case. If one took the one-sided methods seriously, and if there were residual profits, the residuals would be assigned to whichever component of the enterprise was *not* examined to determine the transfer price, or, if one used a "fourth" method, they might be divided. Similarly, if one enforced the "developer-assister" seriously, the profits would be assigned to whichever component was determined to be the "developer" of the intangible, which matter was not foreordained by any idea reflected by the regulations, and which might be determined differently with respect to different intangibles and different development projects. And if one used a cost-sharing approach, the taxpayer could play a significant role in determining *ab initio* how the residual would be divided and assigned.

This movement in the interpretation of the "separate enterprise" standard is slightly paradoxical, in that it is a movement away from an ideal based on the *primacy of residence*, but it was achieved as part of an effort to strengthen residence basis taxation, and in an era that extolled the principle of residence as the juridical touchstone of international taxation (and correspondingly exalted "capital export neutrality" as its theoretical or economic touchstone).

But for our contemporary perspective, the shift was meaningful in a more important respect. For although the Carroll position in some sense undermined or backtracked on the "classification and assignment" approach, according primacy to the source with respect to business profits, it did so in a manner that reaffirmed the role of value creation in the formulation of rules. This is because the justification for assigning the residual to the parent was the *assumed economic role of the parent in producing the residual profit*. The modification effected by the 1968 regulations—leaving the residual indefinitely assigned, to be determined by essentially a discretionary process—represented a *redefinition of the "value creation" notions* embedded in the original system as developed by the League and expressed in Art. 9 of the 1963 OECD Model Tax Convention because the U.S. regulations

248. Allocation of Income and Deductions Among Taxpayers; Determination of Sources of Income, 31 Fed. Reg. 10, 394 (proposed Aug. 2, 1966).

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emphasized the ownership of passive "entrepreneurial" assets and risks rather than the performance of active "entrepreneurial" (managerial) business functions. This move, it can be said, *created the second paradox of the new regulations*: while in an open market transaction the residual return may generally accrue to the legal owner of non-routine intangibles, the application of this market logic to controlled transactions rendered the system only more arbitrary and less able to capture the true contributions to the firm's value creation and coherently assign taxing rights to the jurisdictions involved.

B. Internationalization of the 1960s Rules: the 1979 OECD Guidelines

The mid-1960s Treasury regulations eventually had a poor record of success, and had many, now widely recognized failings. But those regulations had teeth: they tightened tax enforcement. For one thing, the Treasury made them retroactive—they were, after all, "interpretive" regulations, another circumstance that gave rise to confusion about the real novelty of their provisions. By 1971, United States businesses successfully lobbied the new Nixon Administration to adopt the so-called Domestic International Sales Corporation (DISC) provisions, a tax-based export subsidy that was ultimately declared to violate the General Agreement on Tariffs and Trade (GATT). But much of the impetus behind the DISC provisions was the impact of Subpart F and the new regulations, which businesses felt it hurt the competitive position of United States-based companies.

The fate of these regulations, like their background, needs to be understood in light of more general economic developments and policies, especially the outcome of the United States' balance of payments conundrum. In the first place, whatever their ultimate implications, there is little doubt that the most immediate effect of the regulations was on the "outbound" situations, that is, on the foreign profits of United States TNEs. The regulations were made retroactive, and the Internal Revenue Service began examining years of the corporations from the late 1950s, on the basis of the provisions of the regulations, even before the regulations were final.

On August 15, 1971, President Nixon announced his "New Economic Policy." This policy involved abrogation of the Bretton Woods Agreement providing for fixed exchange rates. A new international system of flexible or floating exchange rates would be established. Also in connection with this policy, the United States would adopt the "domestic international sales corporation" (DISC) proposals, deferring 50 percent of United States income taxes on export transactions.

The abrupt abrogation of the Bretton Woods system was an international shock, and its merits have been widely debated. But it did resolve the long-standing United States balance of payments problem; the interest equalization tax and direct investment controls were ended by 1974. The original motivation for the 1960s transfer pricing reforms were, thus,

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eliminated. But those rules soon developed a life of their own. As detailed elsewhere, Professor Stanley Surrey, who had been the Assistant Secretary of the Treasury for Tax Policy in the Kennedy-Johnson Administration, spearheaded an "export campaign" to promote the new rules as an international "arm's length" standard.[249] Both United States and foreign TNEs launched a spirited effort to eliminate the use of formula apportionment by the states of the United States, arguing that that use interfered with the power of the United States to conduct foreign policy with the "one voice" of the Federal Government.[250] When three European states complained that the United States' DISC initiative violated the GATT, the United States counterclaimed that the failure of those governments to adhere to the "arm's length" standard in connection with their territorial tax systems represented such a violation as well. This claim was dismissed, but only as part of a compromise that resulted in inclusion of a directive to adhere to the "arm's length" standard in a Subsidies Code adopted in 1978 in connection with the Tokyo Round of GATT negotiations.

All of this led to the adoption by the OECD of Transfer Pricing Guidelines in 1979 which largely followed the principles of the United States regulations. But in the course of the campaign to establish the 1960s rules as an "international norm," and particularly in connection with the attack on the states' use of formulary methods, the advocacy of "arm's length" acquired the quality that led its adversaries to characterize it as "theological." The 1979 OECD Report described the strict version of the ALS that no longer perceived "separate accounting" as merely a primary method of a hierarchy intended to eventually "result in a fair allocation of income" among states. Rather, it treated the ALS as an end in itself, not as one tool to achieve some "underlying" idea that might be categorized as derivative of the "origin of income" principle established for source taxation. As such, ideas akin to "value creation" were not used to deduce, introduce, or even justify new interpretations. Transfer pricing outcomes that conformed with the arm's length standard were equated to "proper" inter-nation income allocations.

Hence, the 1979 OECD Report discerns as the basic challenge "the need to adjust the actual price to an arm's length price, *in order to arrive at a proper level of taxable income*."[251] These prices were to be determined on the basis of a functional analysis that took the risk structures into consideration[252] and generally recognized the "actual transaction as the starting point" and not, in other than exceptional cases, disregard or substitute other transactions for

249. Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, TAX NOTES, 625, 646–51 (1986).
250. *Id.* at 625–28 (1986).
251. OECD, Transfer Pricing and Multinational Enterprises (1979), at 9 (emphasis added).
252. *Id.* at 17, dubbing a possibly resulting structure one of a risk-bearing, residual profits claiming "principal" and an auxiliary, limited-profit "agent," a dichotomy rooted in market mechanisms but absent within MNEs.

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them,[253] meaning, too, that "intra-group contracts" were deemed decisive if they were not a mere sham.[254] And the 1979 Guidelines expressly approved the use of cost sharing agreements, called "cost contribution arrangements" by those guidelines,[255] notwithstanding the fact that, as the Treasury White Paper issued in 1988 would acknowledge,[256] as of 1979 the United States alone among the OECD-members had ever authorized the use of such arrangements.

It was only in response to increasing practical problems with this system—especially outbound intellectual property transfers in the pharmaceutical industry to Puerto Rican companies entitled to certain benefits under United States domestic law—and to increasingly articulate academic critique, that the United States Treasury had—at least on the surface—to respond to doctrinal arguments on the reasonableness of equating pricing under the "arm's length" system with a "proper" international profit allocation to economic value producing "source" countries.

C. The "Reforms" of the 1980s and 1990s

1. *1988 United States White Paper*

The United States Treasury issued its congressionally mandated study in October 1988.[257] This "White Paper" set forth concepts that now seem rudimentary in light of the further development of the United States regulations and the OECD Guidelines. Yet, although most of its recommendations would fall by the wayside in, or be substantially transmogrified by those Guidelines and regulations, its discussion played a critical role in the revision of the rules, and is reflected seriously by the post-Guidelines development of the OECD's approach, including the BEPS project. Moreover, it is important to understand that the White Paper adopted a myopic and mechanical view of the economics of the transfer pricing problem, a circumstance which has had the serious long-term consequence of confining both national and international policy discussion within unduly narrow channels.

The White Paper recognized the issues identified by the critics of the "arm's length" regime—that "[t]he primary administrative difficulty relating to transfers of intangible property is the failure of the regulations to specify a so-called fourth method of income allocation for situations in which

253. *Id.* at 19.
254. *Id.* at 20, although a bit opaquely formulated, the report makes clear that "underlying reality" should only be considered if contractual agreements were altered arbitrarily or otherwise suspicious ("in such cases").
255. Organisation for Economic Cooperation and Development, Report of the Committee on Fiscal Affairs, Transfer Pricing and Multinational Enterprises, 55–62 (1979).
256. United States Treasury Dep't, *A Study of Intercompany Pricing* (1988), issued as Notice 88-123, 1988-2 C.B. 458, 182 – 83 [hereinafter cited as White Paper].
257. *Id.*

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comparable transactions do not exist;"[258] that "because an integrated enterprise is presumably more efficient, it will be able to execute an integrated economic activity at a lower cost than a series of independent firms whose joint efforts are necessary to execute the same series of transactions," which "creates a 'continuum price problem,' a situation in which the sum of the returns for separate services rendered by independent parties is less than the actual return of the combined group."[259] But the White Paper stumbled in responding to the problem. It argued that microeconomic theory posits an "equality between revenue and the sum of returns to each factor of production," and that "one should measure the factors of production used by each related party and compute the returns that each one would earn on its best alternative use in the marketplace."[260]

This implies that "a competitive firm's gross revenue, which equals price times quantity of output, will be equal to the returns that the factors it employs could earn in the marketplace."[261] The key to accomplishing this task was "functional analysis," a procedure "not explicitly mentioned in the regulations," but rather "outlined in the IRS Manual," which had "been found to be a useful place to start in transfer pricing situations."[262]

On the basis of this analysis, the White Paper outlined new pricing methods, all clearly designed to address the circumstance that comparable transactions were rarely available. The first innovation was to distinguish between "exact" and "inexact" comparables, and to provide for the use of the latter. The second was to devise a system where neither exact nor adjustably "inexact" comparables could be found. The White Paper said you could still determine for each of a group's factors or functions an "arm's length return" and use those returns as a basis for making an allocation. It added that this method, which the White Paper called the "basic arm's length return method" (BALRM), might be supplemented by a profit split.[263] The Paper defended this "approach" as "equally consistent with the basic goal of the arm's length principle, which is to use information about unrelated parties operating at arm's length to determine the allocation of income in a related party setting."[264] It said the "traditional approach" sought "prices that the firm's outputs would command in the marketplace," whereas this "alternative approach" aimed to "determine the returns that the firm's factors would earn in the marketplace."[265]

The U.S. White Paper described "the goal of a market-based approach" as "to ensure that the *return to an economic activity is allocated to the party*

258. *Id.* at 3.
259. *Id.* at 122–23.
260. *Id.* at 129.
261. *United States Treasury Dep't*, *supra* note 256, at 130.
262. *Id.* at 146.
263. *Id.* at 65.
264. *Id.* at 130.
265. *Id.*

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performing the economic activity,"[266] and that "transfer prices are supposed to reflect the contribution of the activity and assets utilized in each location to economic income."[267] But instead of an acknowledgment of the failure of the contemporaneous arm's length standard fostered in the 1960s, the White Paper—referencing the "zero profit" thesis—sought to diminish the significance of the continuum price problem.[268]

Nevertheless, the White Paper implicitly confirms that "source taxation" is a function of the "value creation" of the firm and that it should be priced "correctly" to effectuate the idea of allocating business profits. But, it does so by employing an exclusively "production cost" logic to measure the "economic contributions to income." To the Treasury, the "continuum price problem" was rightly defined as "a situation in which the sum of the returns for separate services rendered by independent parties is less than the actual return of the combined group," but wrongly assumed to be exclusively a consequence of firms utilizing *production technology*.[269] Consistent with this logic, the White Paper proposed a solution which perceived the integration savings to organisations solely as a return to intangible capital. Therefore, the intangible capital owning group entity should be allocated the residual return, if necessary, through application of the BALRM or the "profit split method" (PSM). The PSM, which the Paper said should be used if both parties "*owned*" significant intangible capital,[270] was set to "identify the intangible income attributable to the relevant line of business and then split that income according to *the relative value* that the marketplace would put on each party's significant intangible assets had they been employed by independent parties operating at arm's length."[271]

In brief, Treasury's reaction displayed

(i) that the "continuum price problem" exists and that it is essentially a "value creation" and a "source" taxation problem, and thereby implicitly confirmed that internal "value creation" was principally a valid category of framing the discussion on the goals tax transfer pricing in a source-based international tax system should achieve; but
(ii) approached this problem by employing market theories which are questionable in real-life markets ("zero profit theory") and which created, through a narrow "production cost logic," a system inappropriate in a firm value creation context.

This entails two major caveats:

(i) the assumption that intangible capital ownership would attract the residual profits of a firm effectively re-characterizes an internal

266. *United States Treasury Dep't*, *supra* note 207, at 122 (emphasis added).
267. *Id.* at 123.
268. *Id.* at 128.
269. *Id.* at 123.
270. *Id.* at 160-161.
271. *Id.* at 164.

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"routine" function (ownership) into the entrepreneurial function it might be between independent parties; and
(ii) based on this economically artificial assumption, profit allocations are made possible that are arbitrary (from an internal "value creation" perspective).

The assumption led to an increased importance of the "developer-assister rules" to curb manipulative schemes. In fact, the final BEPS reports are to a considerable extent an elaboration of this logic, as they substantially assume intangible capital as the "reason" of synergy rents, but try to address the mechanism by which these assets are allocated among MNE entities. Capturing value creation, it can be said, was set as the goal of the White Paper's analysis, but the goal would not, in the ensuing regulatory and Guidelines development, coherently find its way into the tax transfer pricing system.

It is in this sense we refer to the implications of the White Paper as "hybrid/schizophrenic." We call the system introduced by the White Paper "hybrid/schizophrenic" from the perspective of value creation because it is an odd amalgam based on an implicit acknowledgment that aligning outcomes with firm value creation is inherent in the principle of source taxation of business income and establishes methods, particularly the profit split, that it presumes to capture "relative value" of contributions to firm income. But it does so based on market analogies that screw up and undermine that very goal by characterizing (intangible) property ownership and conditions and risk-bearing as decisive factors.

2. *The Development of the United States Regulations, 1992-94*

The White Paper was followed by a series of proposed regulations in the United States, leading to final regulations promulgated in 1994.[272] The OECD would issue Guidelines in 1995 revising the 1979 Guidelines.[273] As in 1979, the 1995 Guidelines would largely be shaped by the concepts in preceding United States regulations. But unlike the 1979 version, the final Guidelines reflected a public exchange of views between the OECD and the United States Treasury, and the final Guidelines embodied substantial departures from the regulations of the United States.

The first concrete "reform" proposal was embodied by proposed Treasury regulations issued in January 1992.[274] These proposals followed the White Paper in its wrestling with the problems of "comparability." The proposed regulations introduced new "methods" applicable to intangible property "transactions," which recognized the attenuated nature of "comparability" in

272. *See generally* Prop. Treas. Reg. §1.482, 57 Fed. Reg. 3571 (proposed Jan. 30, 1992); Temp. Treas. Reg. §1.482T (1993); Treas. Reg. §1.482, 59 Fed. Reg. 34971-01(1994).
273. *See U.S. Firms, IRS to Benefit from OECD Tax Rules, Treasury Says*, Treas. RR-483 (July 27, 1995).
274. Prop. Treas. Reg. §1.482, 57 Fed Reg. 3571 (proposed Jan. 30, 1992).

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that context. The methods were the "matching transactions,"[275] "comparable adjustable transaction,"[276] and "comparable profits" methods.[277] The first was preferred, and determined the price based on "uncontrolled" transactions that resembled the "controlled" transaction as to "contractual terms" and "economic conditions;"[278] the second explicitly contemplated that comparability would ordinarily be attenuated;[279] the third rested on the BALRM notions of the White Paper.[280] The proposed regulations maintained the three "traditional" methods for transfers of tangible property, although it eliminated any priority between resale price and cost-plus,[281] and introduced the two new methods suggested by the White Paper, comparable profits and profit split, also introducing the distinguished "comparable" and "residual" profit split methods.[282]

But, these proposed regulations also introduced an idea of a "comparable profits interval" (CPI), which was to be applied with respect to all of the "single-component" ("one-sided") methods (resale price, cost-plus, and comparable profits).[283] Under this proposal, the government could construct an "interval" based on the use of comparable profit levels derived from a range of enterprises "comparable" to the "tested party" (one component of the group), and the taxpayer's transfer price would be respected only if it produced profits at some point on the interval. If that price did not produce that result, the government could determine a price that generated profits "at the most appropriate point" on the interval.[284]

These proposals, with their effort to be faithful to the idea of arm's length and its attendant notion of "comparability," were unsatisfactory to the critics of arm's length—including proponents of a move toward fractional apportionment, who approved the introduction of some profit split methods. But the CPI feature of these regulations proved to be anathema both to foreign and OECD officials, and to the affected taxpayer community. To the former, the regulations elevated the direct measurement of profits to too high a level of importance. To the latter, the power of the government both to construct an "interval" and to unilaterally determine a "most appropriate"

275. Prop. Treas. Reg. § 1.482-2(d)(3)(v).
276. Prop. Treas. Reg. § 1.482-2(d)(4).
277. Prop. Treas. Reg. § 1.482-2(d)(5).
278. Prop. Treas. Reg. § 1.482-2(d)(3).
279. Prop. Treas. Reg. § 1.482-2(d)(4).
280. Prop. Treas. Reg. § 1.482-2(d)(5).
281. Prop. Treas. Reg. § 1.482-2(f).
282. Prop. Treas. Reg. § 1.482-2(f)(3).
283. *See id.* at § 1.482-2(d).
284. Prop. Reg. § 1.482-2(f) (withdrawn). These proposed regulations amplified the "developer-assister" concept, Prop. Reg. § 1.482-2(d)(8) (withdrawn), and set forth articulate rules governing cost-sharing, which included an explicit requirement that the cost shares be proportionate to the anticipated benefits of the development involved. Prop. Reg. § 1.482-2(g) (withdrawn). The regulations proposed in 1966 pertaining to cost sharing had included such a requirement, Prop. Reg. § 1.482-2(d)(4)(iv), but the requirements were not included in the final regulations issued in 1968. Treas. Reg. § 1.482-2A(d)(4).

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point on the interval[285] posed too great a threat of overly aggressive adjustments.

In June 1992, the Committee on Fiscal Affairs of the OECD formed a Task Force to respond to the 1992 proposed regulations.[286] The Task Force did not include representatives of the United States, but the United States participated as an observer in the Task Force deliberations.[287] The Task Force issued a Report in January 1993, shortly before publication of a revised set of proposed regulations.[288] The Task Force issued a number of objections to the proposed regulations, but it emphasized the question of the consistency of periodic adjustments under the statutory "commensurate with income standard" with the "arm's length standard;" and the role of the comparable profits method as a mandatory check on the use of all but the comparable uncontrolled price method.[289] The Task Force also manifested concern with the priority of methods, sought to have the regulations express a preference for the traditional transactional methods, and discouraged the use of the comparable profits method.[290]

Thus, in January 1993, after an election in which the victorious opposition candidate advocated stricter taxation of foreign companies operating in the United States,[291] the Treasury, much with the co-operation of the incoming Administration, issued a new set of proposed[292] and temporary[293] regulations with standards quite relaxed from those issued a year earlier. These regulations completely abandoned the terms "matching," "comparable adjustable transactions," and any explicit notion of inexact comparables as discussed in the White Paper.[294] They did retain the so-called profit methods, comparable profits, and profit split (comparable and residual).[295] They retained only a skeleton of the CPI rule in the form of the arm's length range: an interval or "range" could be constructed, but with respect to any

285. Prop. Treas. Reg. § 1.482-2(d)(5), (f)(1), 57 Fed. Reg. 3571-01 (proposed Jan. 30, 1992).

286. *See* Org. for Econ. Co-operation and Dev. [OECD], *Intercompany Transfer Pricing Regulations Under U.S. Sec. 482 Temporary and Proposed Regulations*, ¶ 1.7 (1992), http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=OCDE/GD(93)131&docLanguage=En [hereinafter 1993 OECD Letter].

287. *Id.* ¶ 1.2.

288. *Id.* ¶ 1.7.

289. *Id.* ¶ 2.5.

290. *See id.* ¶¶ 2.1-2.4.

291. *See* John H. Cushman, *The 1992 Campaign: Corporate Taxes; Clinton Seeks Taxes on Hidden Profits*, N.Y. TIMES (Oct. 24, 1992), http://www.nytimes.com/1992/10/24/us/the-1992-campaign-corporate-taxes-clinton-seeks-taxes-on-hidden-profits.html.

292. *See* Prop. Treas. Reg. §1.482-1, 58 Fed. Reg. 5310 (proposed Jan. 21, 1993).

293. *See* Temp. Treas. Reg. §1.482-1, 58 Fed. Reg. 5263 (proposed Jan. 21, 1993).

294. Prop. Treas. Reg. §1.482-1, 58 Fed. Reg. 5310 (proposed Jan. 21, 1993); Temp. Treas. Reg. §1.482-1, 58 Fed. Reg. 5263 (proposed Jan. 21, 1993).

295. The regulations governing the profit split method were reserved in the Temporary Regulations, but set forth in the Proposed Regulations. *See* Temp. Treas. Reg. § 1.482-5T (1993) (comparable profits method; Prop. Treas. Reg. § 1.482-6T (1993) (profit split method). The provisions set forth are substantially carried forward to the regulations currently in force. Treas. Reg. §§ 1.482-5, 6 (comparable profits method and profit split method).

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method (including comparable uncontrolled transactions) so long as only a single method was used (and a single profit indicator if the comparable profits method was used).[296] Thus, the range could be constructed with measures other than comparable profits. The range could be constructed by the taxpayer in defence of its allocation; a price would be upheld if it generated results anywhere along the range.[297] Gone was the authority of the government to place the price at any "most appropriate" point.

But most importantly, instead of the notion of inexact comparables and in continuing recognition of the problem of comparability, the 1993 temporary regulations introduced an elaborate set of rules for determining when an uncontrolled transaction was comparable to the controlled situation under examination.[298] Comparability was to be determined with respect to five sets of circumstances: functions, risks, contractual terms, economic conditions, and additional factors.[299]

In 1993, the OECD issued a second Report of its Task Force with respect to the revised 1993 regulations.[300] This Report expressed satisfaction with changes made by the revised proposals, particularly with respect to the introduction of the "best method" rule, and the elimination of the use of the CPM as a mandatory check on all other methods.[301] But the second Report also set forth a series of concerns set forth in the first 1993 Report, which it said were continuing with respect to the revisions, as well as a set of new concerns prompted by the revisions.[302] Most of the continuing concerns focused upon the CPM, with the Task Force arguing that its relaxed standards of comparability be clarified, if not narrowed, that a clearer preference for the transactional methods be expressed, and that the CPM be confined to abusive cases.[303] The Report continued to express concern that periodic adjustments might not be compatible with the arm's length standard and voiced reservations about the use of information not available to the parties *ex ante* in making adjustments.[304] The Report also expressed the view that, especially in constructing an arm's length range, the

296. Temp. Reg. § 1.482-1T(d)(2). The provision is carried forward in the final regulations, in force today, Treas. Regs. § 1.482-1T(e).
297. Temp. Treas. Reg. §1.482, 58 Fed. Reg. 5263, 5267 (1993).
298. *Id.* at 5266.
299. Temp. Reg. § 1.482-1T(c)(3)(i)-(v). These are carried forward in the final regulations, in force today, which describe them as "functional analysis;" "contractual terms;" "risks;" "economic conditions;" and the character of the "property or services" subject to the examined transactions. Treas. Reg. § 1.482-1T(d)(3)(i)-(v). The 1993 proposed regulations set forth no provisions concerning cost-sharing arrangements. The Treasury withdrew all provisions of the 1992 proposed regulations *except* those governing cost-sharing. The simultaneously issued temporary regulations, however, did not include the provisions of the 1992 proposed regulations governing cost-sharing, but instead simply included, as Temp. Reg. § 1.482-7T, the text of the provisions of the 1968 regulations (Treas. Reg. § 1.482-2A(d)(4)).
300. 1993 OECD Letter, *supra* note 286.
301. *Id.*¶¶ 2.7, 2.11.
302. *Id.* ¶ 2.4
303. *Id.*¶¶ 2.19-2.22.
304. *Id.* ¶¶ 2.23-2.33.

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regulations should "allow the evidence of all methods to be used in conjunction to determine transfer pricing adjustments."[305]

Among the concerns expressed specifically in relation to the revisions, the Task Force found the tightened standards of comparability applied to the primary transactional methods, comparable uncontrolled price for tangible property transactions, and "comparable uncontrolled transaction" for intangible property transactions problematic.[306] The Task Force also objected to the lessened standards of comparability for CPM, expressing concern that this would lead examiners to resort too quickly to that method.[307] And the Task Force Report, despite its stress on a preference for transactional methods, objected to certain restrictions the 1993 proposals had imposed on the profit split method.[308]

The 1993 regulations were largely made final in 1994.[309] The final regulations made concessions in the direction of the OECD Task Force Report principally by restoring the role of inexact comparables with respect to all methods, and by removing "elective and other procedural barriers to the use of profit split and 'other' (*i.e.*, unspecified) methods," as well as certain limitations on both the profit split and CPM methods.[310] It did not make changes in relation to the comparability standards for any of the methods, retaining the strict standards for CUP and CUT, the relaxed standards for CPM, and did not establish any priority of methods. Instead the final regulations placed greater stress on the best method rule; the preamble to the final regulations said it was "critically important" this method be properly applied.[311]

The preamble stressed not only that the essential structure of the 1993 proposals was kept intact, but that its essential conceptions of comparability and the use of a single best method lay at the core of a new regime.[312] The preamble stated that "both the format and the substance of the final regulations are generally consistent with the 1993 regulations;" and that "[t]he most noteworthy feature of the 1993 regulations in comparison to earlier versions of the regulations under section 482 was the emphasis on comparability," which "feature of the 1993 regulations was generally well received by taxpayers and foreign governments."[313] It said that "[t]he final

305. 1993 OECD Letter, *supra* note 286, at ¶ 2.16. *See also id.* ¶¶ 2.14–15.
306. *Id.* ¶¶ 3.1-3.13.
307. *Id.* ¶¶ 2.19-2.20.
308. *Id.* ¶¶ 3.21-.25.
309. Treas. Reg. §1.482, 59 Fed. Reg. 34971-01(1994). The Treasury did not at the time finalize regulations governing cost-sharing. Those were made final in 1995. Treas. Reg. § 1.482, 60 Fed. Reg. 65553-01 (Dec. 19, 1995) (promulgating what is now Treas. Reg. § 1.482-7A). That version of the regulation was superseded by the current version of the cost sharing regulation, Treas. Reg. § 1.482-7, at the end of 2011. TD 9568, 76 Fed. Reg. 80,882 (Dec. 22, 2011).
310. Treas. Reg. §1.482, 59 Fed. Reg. 34971-01, 34975-34976 (1994).
311. *Id.* at 34976.
312. *See id.* at 34975.
313. *Id.*

regulations adhere to this emphasis, and in some cases increase it."[314] The removal of restrictions on profit splits, CPM, and other methods meant "the emphasis on comparability and the importance of the best method rule are increased."[315]

These conceptions would come to dominate the administration of this new regime in the ensuing two-plus decades.

3. *Implications of the United States Regulatory Innovations*

Before proceeding, it is worth noting four features of the 1994 revision of arm's length. The first is that while the official materials, proposed regulations, and their accompanying preambles carefully avoid any reference to the prevailing, outstanding critique of the arm's length idea—and rely on or refute this critique even less—the regulatory texts evince an almost studied tendency to incorporate the language of that critique and to obscure the difference between the regulatory use of terms and the function of parallel terms in the literature criticizing arm's length. For instance, internalization theory speaks frequently of firm organisation as an alternative to contracting among firms that otherwise constitute components of an organisation. The 1994 regulations make contractual terms a key element of comparability,[316] but the contractual terms spelled out by a controlled organisation really have nothing to do with any contract between enterprises that are conceived as the (displaced) alternative to internal organisation. Similarly, internalization theory posits in part that internal organisation forestalls risks to the enterprise that might arise in the absence of organisation; the comparability rules are concerned with localizing (by component, and hence by taxing jurisdiction) risks that pertain to the business enterprise irrespective of the form it takes (what we might call "external risks").[317] Internalization theory posits that the choice (substitution process) between hierarchy and market organisation is determined by external economic conditions. The comparability rules use a much more general notion of external conditions (and a similar point might be made with respect to the "property and services" characteristic).[318]

Perhaps most saliently, the CPI notion of the 1992 proposals, the arm's length range of the 1993 temporary regulations, and the final 1994 regulations appear to be an effort to deflect the continuum price indictment of the entire arm's length system, at least as embodied in the 1960s regulations.[319] But the interval of the CPI, and much more the range, are radically different from the "continuum" the price problem depicts. The continuum price envisioned by the critique has ends defined by the differing

314. *Id.*
315. *Id.*
316. Treas. Reg. § 1.482, *supra* note 309, at 34991.
317. Glenn R. Carroll & David J. Teece, *Firms, Markets, and Hierarchies: The Transaction Cost Economics Perspective*, 18–20 (1975).
318. *See* Treas. Reg. §1.482, 59 Fed. Reg. 34971-01, 35022 (1994).
319. *See* TD 6952, 33 Fed. Reg. 5848; TD 6998, 34 Fed. Reg 933 (Jan. 17, 1969).

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agreement among it and its subsidiaries would provide for the subsidiaries to bear the "costs" of development, including its "risks," in proportion to their respective "anticipated benefits" of the development. They might bear the costs simply by "funding." The costs would be proportionately charged to the subsidiaries and a payment might be made to the parent for the charge, or the parent might simply forego their shares of the deductions and the deductions would be claimable by the subsidiaries with some sort of receivable set up and paid at some point.

By the time of BEPS, cost-sharing agreements had ceased to be so simple. Provisions had to be made for "buy-in" payments for in-kind contributions by the participants of property or services produced outside the arrangements and for current in-kind contributions made in compliance with the arrangement. Still, however, the prevailing rules permitted centralization of the research activities with account taken of funding and other contributions by the non-central parties.

But, the conceptions that preceded BEPS in the OECD's work, as well as the initial work under BEPS, bore some obvious tensions with this kind of straightforward and readily manageable CCA structure. The AOA and the business restructurings Issues Notes included as Chapter IX of the Guidelines elevated the concept of risk and "control" of risk, and the 2014 recharacterisation deliverable, as indicated above, imported the concept strongly into Chapter 1 of the Guidelines. It made little sense to leave such a concept out of the question in CCAs, but incorporating it into the CCA rules meant that particularized inquiry into questions of "risk" and "control" would make examination of CCAs considerably more complicated and considerably more unpredictable. Similarly, the 2012 OECD Discussion Draft on intangibles and the 2014 Action 8 deliverable reject pretty much altogether the "developer-assister" idea of deferring returns to "assisters" until the embodiment of development in identifiable property, and mandate dividing the return on intangible property in accordance with the contributions to the "development, maintenance, protection, and enhancement" (DEMPE) of the intangible.

The early deliverable on CCAs reflected the conceptual changes foreshadowed by the other deliverables, and by the work of the OECD on AOA and business restructurings. First, the deliverable changed the provisions of the Guidelines concerning permissible participants in CCAs. The 2010 Guidelines had required only that a party have "a reasonable expectation that it will benefit from the CCA activity (and not just from performing part or all of that activity)." It required that the participant "be assigned a beneficial interest in the property or services that are the subject of the CCA, and have a reasonable expectation of being able directly or indirectly (e.g., through a licensing arrangements or sales, whether to associated or independent enterprises) to exploit or use the interest that has been assigned."[597] The 2014 deliverable changed this, requiring that a

597. 2010 OECD Guidelines, *supra* note 424, ¶ 8.10.

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The second feature of the extensive comparability idea of the 1993-94 regulations worth noting is that the five conditions listed all but invariably represent matters not measured by any conventional accounting standard or practice.[327] This is especially true of functional analysis, and risk, both of which pertain to internal matters to which a company's financial statements are pertinent, if not crucial.[328] But, as noted above, functional analysis in its origin constituted a set of instructions to middle level agency field personnel about the institution of examinations, which, "by a set of curious chances," to borrow W. S. Gilbert's phrase, evolved into a major principle embodied in the policy prescriptions of major international organisations, to say nothing of the internal law of numerous nations. But what exactly is a "function?" How do you know if functions are distinctly associated with particular entities in a multiple level overall organisation? If so, how does one determine the association? And if not, how does one break any function apart among the various components? Similar observations can be made with respect to "risk," "economic conditions", and "property and services." None of these have an exact correspondence to accounting measures or categories. Contractual terms have fewer indeterminacies if written contracts exist. Absent these terms, and even with them, there are ambiguities; there is an ever-present issue of the possible incompleteness of those contracts, and again, no accounting measures to assist in resolving them.

The third feature of the comparability rules is to understand that, while they may have been conceived or designed as an effort to revive the comparability idea and rescue that idea from the realm of pure fiction, it was simultaneously foreseeable that their operation would have the exact opposite effect. To demonstrate this point, one can resort to the original idea of comparability in a context where it works perfectly. Take a domestic context, a shareholder of a wholly owned corporation, sells a used automobile with a "Blue Book" value of $20,000, to her wholly owned corporation, for $100,000. The Blue Book value is a measure of a comparable uncontrolled sale. It takes no genius to determine that the shareholder has sold the car for $20,000 and paid a very poorly disguised dividend of $80,000. In this case, the comparable price (the Blue Book value) is the starting point of analysis: once you know it, you know the result. You do not need to know anything more about the car that was sold.

But under the 1993-94 regulations, the process is reversed: you begin with an analysis of what is to be compared.[329] And it is a detailed analysis. Moreover, once you are done with this analysis, the notion of comparability is attenuated: there are no Blue Book values; you find something as similar as you can find, and defend your price that way. But because the five criteria are applied under complex rules and the degree of comparability demanded

327. *See* Temp. Treas. Reg. §§ 1.482-1T(c)(3)(i)-(v) (1993).
328. *See id.* §§ (i)-(ii).
329. *See* Temp. Treas. Reg. §1.482, 58 Fed. Reg. 5263, (1993); Treas. Reg. §1.482, 59 Fed. Reg. 34971-01 (1994).

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is slight, it is foreseeable that the initial analysis, though framed as criteria of comparability, becomes virtually the whole basis for the allocation itself. That is, you see that the intercompany contracts assign this profit here and that there, that the risks are located some here, some there, that the loose conceptions of "functional analysis" and "economic conditions" justify this or that assignment of the rewards, and together that becomes the allocation. Finding an uncontrolled transaction that both matches the controlled transaction with respect to the five criteria *and* has a parallel allocation of profits (comparable price, markup, margin) becomes rather auxiliary in character, despite presumably being the dominant step in the analysis. This becomes truer and truer as the degree of comparability demands is lessened, or one says that one or more of the five criteria do not have to be matched, and so on. Thus, the five criteria become not really indicia by which comparability is determined, but direct determinants of the final allocation of profits. This has obvious and acute dangers for the system adopted, especially when, as, and to the extent that the "contractual terms" criteria is elevated in significance.

This leads to the fourth and final point, which grows directly from the other three, especially the third. This system is a radically new one—not an outgrowth of the arm's length idea or the embodiment of that idea in the 1960s regulations. The arm's length idea, in its simplest form, is embodied in the simple automobile example given above, which uses a readily established "comparable uncontrolled transaction." This is not only unexceptionable, but an important arsenal in the enforcement of any income tax system. Conceded by all is that not every or even most or even many situations are as straightforward. The 1960s rules had a logical solution: if no direct evidence like that is available, construct a price that would bring both parties "to the table," so to speak, and that is a market price or arm's length price.[330] That approach is logical, but empirically proven and theoretically confirmed to be flawed: that a whole range of prices would do this, so that the price was not determinate.

But the solution of the 1993-94 regulations was radical and objectionable in that it did not have any real logical defence corresponding to the simple logic that originally underlay the resale price and cost-plus methods. It was no logical or theoretically defensible response to the problems that the original logic had encountered, and was not otherwise coherently related to the notion of employing anything that could be characterized as related to market prices.

D. The 1995 OECD Transfer Pricing Guidelines

1. *Le Côté États-Unis et le Côté OCDE*

As of the mid-1990s, there was perhaps a general impression among interested professionals that the United States' position—moving away from

330. *See* TD 6952, 33 Fed. Reg. 5848; TD 6998, 34 Fed. Reg 933 (Jan. 17, 1969).

arm's length and possibly in the direction of formula apportionment—was a more advanced position than that of the international community, including the United States' major trading partners and particularly the OECD. Such an impression was understandable. In the first place, the reconsideration of the rules had clearly been instigated by the United States Congress, particularly by the 1986 Conference Report, with its derogation of the existing rules.[331] Furthermore, the Congress enacted the "super royalty provision," which obviously posed a question as to its compliance with arm's length. Moreover, the White Paper's tone was somewhat sheepish throughout in its claim that the novel approaches it detailed were fully consistent with the arm's length standard. By contrast, the OECD's pronouncements unceasingly and pointedly claimed fealty to the international standard, in tones conventionally and repeatedly described with words like "ringing endorsement."

But a closer inspection of the actual content of the proposed rules and the comments they elicited, together with an inspection of the directions which the academic and professional critics of arm's length were then advocating, lends fairly convincing evidence that any such general impression was wrong. Indeed, the critics had the situation backward. By the mid-1990s, the critics of arm's length were not advocating any full-fledged international formula method along the lines used by the states of the United States. Rather, they advocated using traditional methods to make marginal allocations to the various components of a transnational integrated group with the residual profit allocated according to fixed and determined criteria, which would not vary taxpayer to taxpayer.[332] The final United States regulations undermined any such general approach with the "best method" rule, which confined any allocation to the use of a single, best method.[333] Even when a residual profit split method was employed, the regulations tied up its use with vague standards as to the manner of allocating the residual and cautionary rules about demonstrating the superior reliability of the data employed.[334] By contrast, the OECD's express views exhibited a much greater openness to the structure of the approach which the critics of arm's length supported, particularly by accepting the use of different methods to construct an arm's length range, and by more realistic views both of the utility of the profit split method and of the manner in which various species of profit splits had been employed as "fourth" or "other" methods under the 1968 United States and 1979 OECD rules.[335]

331. H.R. Conf. Rep. No. 841. 99th Cong., 2d Sess. 11-638 (1986).

332. Stanley I. Langbein, *A Modified Fractional Apportionment Proposal for Tax Transfer Pricing*," TAX NOTES, 719 (Feb. 10, 1992); *Cf.* Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, FLA. TAX REV., 497 (2009).

333. Treas. Reg. §1.482, 59 Fed. Reg. 34971-01, 34973 (1994).

334. *Id.* at 34974.

335. 1993 OECD Letter, *supra* note 286, at 5, 8.

Even procedurally, the OECD as an institution exhibited a significantly greater degree of flexibility and openness than did the United States Treasury. In July 1993, the OECD arranged an informal and largely confidential conference which brought together academic and professional experts from the private sector with OECD officials, and representatives of certain major governments, including the United States, the United Kingdom, and Japan.[336] But the private sector experts, though not all vocal critics of arm's length, were clearly selected as and confined to individuals known to be skeptical of accepted techniques, and open to consideration of significant reform. The conference rejected any immediate move to fractional apportionment but recommended a sort of truce, by expressing a view that (radical) arm's length and (full-fledged) fractional apportionment should be seen as extremes on a continuum, rather than as polar opposites wholly incompatible with each other[337]—a position reflected in the contemporaneous recommendations for expansion of profit splits,[338] and indeed one which, as noted above, was reflected even from the early history of the methods of allocation.

Again, in contrast, the United States Treasury held a hearing on fractional apportionment in 1996.[339] It did not do so of its own volition: it only agreed to do so because one Senator had threatened to place a hold on a nominee for a senior Treasury position if it did not hold such a hearing.[340] But the hearing was lackadaisically organized and publicized; it was prefaced by a statement from the Deputy Secretary voicing full-throated commitment to arm's length[341] and, in contrast to the OECD's conference, it failed to invite the best recognized spokesmen for the critique of the arm's length system.

These circumstances foreshadowed aspects of the document which came to be the central statement of the new regime of the mid-1990s, and, as such, of the arm's length standard as that standard has existed since, the 1995 OECD Guidelines.[342] Although the Guidelines were styled as only a revision of the 1979 document, they were in fact almost entirely new, much as the United States regulations of 1993-94 were.[343] And, as the 1979 document followed the structure and the concepts of the 1968 United States regulations, so the 1995 Guidelines were revised largely along the lines of

336. Brian J. Arnold & Thomas E. McDonnell, *Report on the Invitational Conference and Transfer Pricing; the Allocation of Income and Expenses Among Countries*, TAX NOTES, 900 (Dec. 13, 1993).
337. *Id.* at 907.
338. Avi-Yonah, Clausing & Durst, *supra* note 332, at 3.
339. Treasury's Summers Speaks On Formula Apportionment, 96 TNT 242–23 (Dec. 13, 1996).
340. *See id.*
341. The Deputy Secretary's remarks are reproduced at 96 TNT 242–23 (Dec. 13, 1996).
342. OECD, *Transfer Pricing Guidelines for Multinational Enterprises* (1995) [hereinafter 1995 OECD Guidelines]. The Guidelines are a revision of the 1979 Report OECD, *Transfer Pricing and Multinational Enterprises* (1979), discussed above. The 1995 Report was revised in 2010. OECD, *Transfer Pricing Guidelines for Multinational Enterprises* (2010) [hereinafter 2010 OECD Guidelines].
343. *See generally* 1995 OECD Guidelines.

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the new United States rules. But the 1995 OECD Guidelines were nowhere near as exactly faithful to their United States progenitor as the 1979 version had been to theirs.

As noted above, the OECD Task Force had expressed differences to the first proposed regulations of the United States. The United States changed the regulations substantially, moving quite far in the directions the OECD advised, especially by the abandonment of the mandatory use of the comparable profits method as a check on all transfer prices.[344] But the changes the OECD sought were largely supported, indeed advanced independently, by the affected taxpayer communities, both domestic to the United States and foreign. The OECD then expressed continuing reservations and new reservations on the second set of proposals.[345] The United States did not issue a third set of proposals in response, but finalized the second proposals with a few changes in the directions suggested by the OECD. For the most part, the final regulations ignored most of the OECD's major criticisms.[346]

When it finalized the Guidelines, the OECD responded in kind: it made some concessions with respect to the issues raised in the later 1993 OECD Report but for the most part adhered to the positions there expressed, notwithstanding that those views had been largely ignored by the United States final regulations.[347] The result is that the OECD and United States positions are at odds with each other in important ways—the OECD view exhibits considerably greater understanding of, and even sympathy for, the problems critics have identified with arm's length. Despite their differences, these positions are widely (and to a limited extend validly) viewed as a phalanx defending arm's length against formula apportionment, or any serious move in that direction.[348]

It is certainly true, however, that the OECD Guidelines on a quick inspection appear a determined link in the phalanx. For one thing, an entire subchapter is devoted to a discussion of formula apportionment as a non-arm's length method.[349] That discussion debunks formula apportionment in rather stentorian terms—formula apportionment would "require substantial international cooperation and consensus," which "would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect;"[350] it could permit "tax avoidance to the extent that the components of the relevant formula can be manipulated;"[351] "predetermined formulae are arbitrary and disregard

344. *See generally* 1995 OECD Guidelines.
345. *See* 1993 OECD letter.
346. *See generally* Treas. Reg. §1.482, 59 Fed. Reg. 34971-01 (1994).
347. *See id.; see also* 1995 OECD Guidelines.
348. *See* 1995 OECD Guidelines.
349. 2010 OECD Guidelines at 37.
350. 1995 OECD Guidelines ¶¶ 3.64, 3.66. These provisions are carried forward at 2010 OECD Guidelines ¶¶ 1.22, 1.24.
351. *Id.* ¶ 3.65. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.23.

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market conditions;"[352] formula apportionment "may in fact present intolerable compliance costs and data requirements;"[353] it would present difficulties "compounded by the existence across taxing jurisdictions of different accounting standards and multiple currencies;"[354] it "would raise questions about the relevance of imposing withholding taxes on cross-border payments between group members and would involve rejection of a number of rules incorporated in bilateral tax treaties."[355]

The Guidelines paid no heed to the theoretical objections to arm's length and the corresponding advantages of fractional methods. And for all the cited objections to formula apportionment, the core objection was the difficulty of achieving international consensus.[356] The Guidelines exhibited a corresponding attitude toward the objections to arm's length generally: although the "arm's length principle is viewed by some as inherently flawed, because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses," there is "no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises."[357] But the difficulty of achieving consensus and the lack of widely accepted objective criteria were and are, at least in principle, remediable circumstances; the Guidelines gave no reason for rejecting out-of-hand an approach that at least began to seek solutions to them.

At the same time, too, the Guidelines did not abandon the skepticism previously expressed by the OECD Task Force about the CPM in its various manifestations, although the Guidelines in the end accepted that method as an acceptable or at least permissible method under the arm's length system. The Guidelines gave the method an entity-specific frame and a different name, the "transactional net margin method," (TNMM) and said that "so-called 'comparable profits methods' or 'modified cost plus/resale price methods' are acceptable only to the extent that they are consistent with these Guidelines."[358] The Guidelines' TNMM expressed a preference for using a comparable that involved the same group (and an uncontrolled counterparty) as the intra-group tested transaction;[359] the U.S. regulations at a minimum express no such preference, and may even be read to *preclude* using a transaction of the same group as the comparable uncontrolled transaction. And the Guidelines emphasized repeatedly that the TNMM was to be used as a last resort, which required observing traditional safeguards

352. *Id.* ¶ 3.67. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.25.
353. *Id.* ¶ 3.69. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.27.
354. *Id.* ¶ 3.70. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.28.
355. 1995 OECD Guidelines ¶ 3.72. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.30.
356. 2010 OECD Guidelines at 36.
357. 1995 OECD Guidelines ¶ 1.9. These provisions are carried forward at 2010 OECD Guidelines ¶ 1.10.
358. *Id.* ¶ 3.1. These provisions are carried forward at 2010 OECD Guidelines ¶ 2.56.
359. *Id.* ¶¶ 3.26, 3.34.

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and that very few countries had experience with the method and most considered it "experimental."[360]

In the context of its discussion of the TNMM, the OECD cautioned that the method was one-sided, meaning that it focused, as did cost-plus and resale price, on only a single component of the enterprise.[361] The Committee on Fiscal Affairs (CFA) would return to this phrase in the future, ordinarily with a caution that one-sided methods had a tendency to produce skewed results (a tendency emphasized in the literature critical of arm's length generally).[362] In light of these caveats, the OECD promised "an intensive period of monitoring the application of both traditional transaction methods and transactional profit methods over the coming years, with a view to revising this Report periodically, as necessary, to take into account the result of this monitoring."[363] But the 1995 Guidelines retained many of the stances taken in the 1993 Task Force Reports, which exhibited continuity with some of the directions supported by the critics of arm's length.[364] As between the two transactional profit methods, the Guidelines exhibited a preference for the profit split, which it described as having a greater balance of strength over weaknesses than the balance ascribed to the TNMM;[365] as a method with which some members had some familiarity, in contrast to the experimental TNMM;[366] and which it identified as compatible with a method that identified a residual.[367] The placement of discussion is not necessarily significant, but the OECD, in discussing the profit method, addressed the profit split first and TNMM second in contrast to the U.S. regulations, which set forth the CPM first (in the "-5" regulation) and the profit split later (the "-6" regulation).[368]

Moreover, the Guidelines persisted in suggesting that the arm's length range could be established using different methods as well as different comparables within the same method, thus, at least permitting an analysis which realistically could associate the scope of a range with the residual income as conceived by economic analysis.[369]

The most significant move by the OECD in the direction of the structure of the final U.S. regulations was the Guidelines' full acceptance of the regulations' intricate description of the idea of comparability.[370] The Guidelines accepted a five-pronged approach to comparability, with some

360. *Id.* ¶¶ 3.52, 3.53, 3.55; *see also* Org. for Econ. Co-operation and Dev. [OECD], *Transactional Profit Methods: Discussion Draft for Public Comment*, 8, 16 (Jan. 25, 2008).
361. *Id.* ¶ 3.31. These provisions are carried forward at 2010 OECD Guidelines ¶ 2.26.
362. *Id.*
363. 1995 OECD Guidelines ¶ 3.55.
364. *See generally* 1995 OECD Guidelines.
365. 1995 OECD Guidelines ¶¶ 3.5-3.10.
366. *Id.* ¶ 3.52.
367. 1995 OECD Guidelines ¶ 3.19.
368. Treas. Reg. §§1.482-5, -6, 59 Fed. Reg. 34971-01, 34973 (1994).
369. 1995 OECD Guidelines ¶¶ 1.46-1.47. The same principle is implicit in 2010 OECD Guidelines ¶¶ 2.11, 3.59.
370. *See generally* 1995 OECD Guidelines.

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difference in the definition of the prongs.[371] The Guidelines included risk, the third prong of the U.S. definition, as part of the second prong, functional analysis.[372] Most likely, the Guidelines did this because of the difference in the Task Force reports expressing concerns, taking into account information or objectives identified *ex post*, which the regulations suggest may be taken into account but which the Task Force Report and Guidelines excluded from consideration in determining the comparability of risks. The Guidelines too, to an extent, cured some of the defects in the notion of functional analysis suggested above, because the Guidelines at least identified what it conceived of functions—"design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing, and management"[373]—although the delineations of those categories could hardly be described as crisp, or the process of analyzing them as compact. And in its description of functional analysis, the OECD for the first time articulated a tripartite breakdown of the process of analyzing "functions, assets used, and risks assumed"—which would be a touchstone of much of the CFA's future work.[374]

In place of "risk" as a criterion, the Guidelines included the fifth criterion of "business strategies," the principal objective of the inclusion of which appeared to be to permit taxpayers to take into account startup or other market-making losses.[375] But the inclusion of the five-part comparability schema in the regulations made the Guidelines vulnerable to the same tendency as the regulations—that the criteria set forth as aspects of comparability would instead become a kind of checklist for making allocations directly with external comparables used perfunctorily and to some extent after the fact, creating serious questions whether the determination had any meaningful connection to the supposedly underlying (or overarching) arm's length principle. In a limited way, the Guidelines aggravated this circumstance, by refusing to follow the U.S. regulations in imposing a stricter standard of comparability in the context of the CUP method. Instead, the Guidelines carried forward the Task Force's position by favoring a comparability standard consistent among all methods.

Thus, by 1995 the Guidelines and regulations were both in place. The commonplace view was that the Guidelines hewed more closely to the traditional or historic arm's length approach than did the regulations, and the regulations constituted a greater advance toward a modification of the system that made it friendlier to formulary apportionment. As noted here, that perception was probably misguided, if not diametrically incorrect, but that is not the important point here. The major point is that the discrepancies between the two set the stage for two different paths, two

371. *See* 1995 OECD Guidelines.
372. 1995 OECD Guidelines ¶ 1.23.
373. *Id.* ¶ 1.21.
374. *Id.* ¶1.20.
375. *Id.* ¶¶ 1.32, 1.34.

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different and almost opposite Proustian *côtés*, blazed in the ensuing decade and a half, which in turn partially set the stage for the differences which became palpable during the BEPS-negotiations.

The first was the course of practice under the regulations/Guidelines, which increasingly fell victim to the main vulnerability of both structures, *viz.*, the tendency of the comparability factors to degenerate into criteria for making allocations directly, and the tendency for the comparability examination to degenerate further into giving primary effect to the contractual terms criterion, rendering a system based very heavily on initial taxpayer determinations. The second path was the evolution of the ideas of the OECD, which increasingly tended, in visible contrast to the direction of practice, to seek ways to de-emphasize taxpayer discretion and control of the allocation process, and at the same time to elevate considerations which could have facilitated an effort to address the kind of conflicts the Guidelines perceived as rendering formulary apportionment unacceptable. This latter evolution was accompanied, paradoxically, by an ongoing pattern of OECD expressions to rule out not only any move toward fractional apportionment, but also to eliminate vestigial fractional methods that the OECD Model Conventions, and their predecessors, had historically retained. Thus, both the conceptual discrepancies and the misleading appearances manifested in the Task Force Reports and the Guidelines of the mid-1990s became ever more exaggerated.

2. *Value Creation and the Hybrid/Schizophrenia of the 1995 Guidelines*

As the hybrid/schizophrenic approach[376] to transfer pricing found entry into the OECD Transfer Pricing Guidelines in 1995, these Guidelines, hence, worked with the idea of "aligning outcomes with value creation" in various degrees but incoherently. Firstly, they start as a general matter being concerned with pricing *transfers of value*, which is not necessarily the same as allocating profits/income to the original/functional value creator. References to the value of contributions to transactions are, therefore, mostly employed as meaning "fair market value"[377] of transferred assets or services rendered, often, but not always,[378] regardless of the actual economic

376. As noted above, we call the system introduced by the White Paper "hybrid/schizophrenic" from the perspective of value creation because it is an odd amalgam based on an implicit acknowledgment that aligning outcomes with firm value creation is inherent in source taxation of business income and establishes methods, esp. the profit split, that assume to capture "relative value" of contributions to firm income. But, it does so based upon market-analogies that screw that very goal by characterizing IP-ownership and risk-bearing as decisive factors.
377. *See* 2010 OECD Guidelines ¶6.27.
378. 2010 OECD Guidelines ¶ 6.38 considers a royalty rate reduction in case where the licencee creates part of the value of an intangible asset. Still, value creation is understood as "cost-bearing."
6.38: "In some cases, a distributor may bear extraordinary marketing expenditures beyond what an independent distributor with similar rights might incur for the benefit of its own distribution activities. An independent distributor in such a case might obtain an additional return from the

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act of creating the transferred value. In that sense, the Report ties all methods that apply the arm's length principle to the concept of "options available" as a means to determine the value of transactions.[379] Secondly, if reference is made to the actual act of value creation by group entities in creating the (transferred) assets, it is, akin to the "developer-assister rule" of the U.S. Regulations, equated to cost-bearing in pertinent development/ protection stages of intangible assets by individual entities, regardless of how they re-finance themselves within the group.

The 1995 Guidelines at the outset echo the critique on the arm's length system and thereby implicitly confirm, because they do not attack on a general front, the basic correctness of its findings and that the profit allocation in principle should capture the full economic return to activities performed within a jurisdiction. The 1995 Guidelines introduced the defence line that although the arm's length principle is "viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses," that "[t]here are . . . no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises."[380] And in that vein, the Guidelines do undertake to take value creation—in the sense sketched above—into account when performing the functional analysis[381] or in selecting and applying the transfer pricing methods. Take for instance a problem that is still not fully solved, the tax treatment of economic contributions to the value of intangible assets by distribution entities. The 1995 report, in searching for an appropriate resale price margin, displays its schizophrenia. While it first reasons in purely economic terms correctly that "an appropriate resale price margin is easiest to determine where the reseller does not add substantially to the value of the product," but that

> the resale price margin requires particular care is where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (e.g. trademarks or tradenames) which are owned by an associated enterprise. In such cases, the

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owner of the trademark, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate."

379. *Id.* ¶ 1.16.

380. 1995 OECD Guidelines ¶ 1.9; 2010 OECD Guidelines ¶ 1.10.

381. 1995 OECD Guidelines ¶ 1.21 reads: "The functions that taxpayers and tax administrations might need to identify and compare include, *e.g.*, design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing, and management. The principal functions performed by the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. *While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.*"

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> contribution of the goods originally transferred to the value of the final product cannot be easily evaluate,[382]

it searches for a solution by—still reasonably—assuming that it "should be expected that the amount of the resale price margin will be influenced by the level of activities performed by the reseller."[383] Also, the "resale price margin could be higher where it can be demonstrated that the reseller has some special expertise in the marketing of such goods, in effect bears special risks, *or contributes substantially to the creation or maintenance of intangible property associated with the product*."[384] But in discerning "contributions to the creation of intangible value," it resorts to its odd amalgam of market-analogies based on contractual assignments of cost/risk-bearers and owners of intangibles by stating that "the level of activity performed by the reseller, whether minimal or substantial, would need to be well supported by relevant evidence," and that "[t]his would include justification for marketing expenditures that might be considered unreasonably high; for example, *when part or most of the promotional expenditure was clearly incurred as a service performed in favour of the legal owner of the trademark*."[385] On the other hand, quite like the White Paper, the 1995 Guidelines see ownership of intangibles in the process of creating value as rendering the situation "non-routine."[386] On this (skewed) basis, the Report finds comfort in the—by itself reasonable sounding—conclusion, that

> If it cannot be demonstrated that the intermediate company either bears a real risk or performs an economic function in the chain that has increased the value of the goods, then any element in the price that is claimed to be attributable to the activities of the intermediate company would reasonably be attributed elsewhere in the MNE group, because independent enterprises would not normally have allowed such a company to share in the profits of the transaction.[387]

Another example of the schizophrenic logic in terms of value creation that bears no theoretical novelty compared to the White Paper, nor to the 1994

382. 1995 OECD Guidelines ¶ 2.22 (emphasis added).
383. 1995 OECD Guidelines ¶ 2.24.
384. *Id.*
385. *Id;* This idea of treating "expenditures" as the "value creating activity" is further explained in Chapter VI. There the pertinent paragraphs tell:
6.39 The other question is how the return attributable to marketing activities can be identified. A marketing intangible may obtain value as a consequence of advertising and other promotional expenditures, which can be important to maintain the value of the trademark. However, it can be difficult to determine what these expenditures have contributed to the success of a product. However, it can be difficult to determine what these expenditures have contributed to the success of a product. [emphasis added]
386. *Cf.* OECD Guidelines ¶ 2.25: "If the reseller *possesses* valuable marketing intangibles, the resale price margin in the uncontrolled transaction may underestimate the profit to which the reseller in the controlled transaction is entitled, unless the comparable uncontrolled transaction involves the same reseller or a reseller with similarly valuable marketing intangibles."
387. *Id.* ¶ 2.26.

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U.S. Treasury Regulations, is found in the OECD's discussion on the application of the profit split method: The OECD first assumes that the ownership of intangibles renders a party to the transaction non-routine as such eligible to book the residual returns from the business activity and, thus, connects the scope of applicability of the profit split method primarily to situations were both parties own significant intangible assets and defines the necessary contribution analysis as a mechanism by which

> The total profits from the controlled transactions under examination, would be divided between the associated enterprises based upon the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances. In cases where the relative value of the contributions can be measured directly, it may not be necessary to estimate the actual market value of each participant's contributions.[388]

The Report sees the strength of this method in that generally "the two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations,"[389] but it does not question that the valuation of the contributions thereby is not aligned with the weight the firm that produces the economies of scale has a different internal view on the importance of ownership and cost-bearing—both are routine functions from an inside value creation perspective. The method is, thus too, justified on the basis of economic concerns it eventually fails to address.

E. Summary: Value Creation, Residual Profits, and the Contemporary Arm's Length Standard Pre-BEPS

Clearly, as detailed above, the developments of the middle period encompassing the era from the early 1960s to the mid-1990s, dramatically transformed the content of the arm's length principle, at the same time the transfer pricing issue was of ever-escalating significance. A review of the standard's evolution from its inception to the formulation in the 1995 Guidelines, particularly insofar as the treatment of residual profits was concerned, is in order.

The foundation of any standard is the classification and assignment system based upon the principle of economic allegiance. The latter principle is closely analogous to the modern, emergent notion of value creation.[390] The arm's length principle emerged in the early 1930s, largely through a Report by an author who articulated a view of it that reaffirmed the economic

388. *Id.* ¶ 3.16.
389. *Id.* ¶ 3.7.
390. OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, at 11 (Jul. 10, 2010).

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allegiance principle.[391] This reaffirmation involved the assumption that the residual profit would be assigned in full to a parent controlling entity on grounds that that entity was responsible to the creation of that value.[392] The principle was adopted as part of the Model Convention system in the 1943 Mexico and 1946 London models, but without any affirmation of the corollary that the residual should be allocated in full to the parent.[393] Instead, those Models contemplated secondary methods of allocation which would have spread the residual throughout the integrated group, but clearly on grounds consistent with the linked ideas of value creation and economic allegiance. And in all events, the early ideas placed little stress on contractual allocations, or on any attempt to define inputs, or functions, to which responsibility for the profit was imputed.

The innovations of the 1962-1995 period interpreted arm's length in ways that deviated more substantially from the underlying idea of economic allegiance. The regulations adopted at the outset of this period rested upon established economic conceptions of substitution at the margin, if not comparable market price could be found, one asked, with respect to some component of the group, what was the marginal price that would entice that component, if independent, to enter the transaction.[394] The problem with this eminently sensible approach was that, if applied serially through one-sided methods to all members of the group, it did not definitively assign the entire group profit. What was left was the residual. The system was agnostic as to the assignment of the residual, in contrast to either of the approaches reflected in the 1933-46 developments: unlike the Carroll Report, the system neither explicitly nor implicitly assumed the residual was created by central management; unlike the London/Mexico Models, the system did not expressly or articulately define "backup" methods which divided the residual among the component enterprises in a manner that at least roughly approximated identifying the locales responsible for its creation.[395]

This system proved unacceptable, because of its indeterminacy: it produced *ad hoc* and inconsistent results, and plainly undermined the corporate income tax base. But the task of reforming it generated both controversy and suspicion. In the end, the United States and the world body, the OECD, formulated a system; the foundation of which was the contractual allocation made by an agreement among commonly controlled corporations—and undoubtedly determined by central management itself.[396]

391. *See* Hubert Hamaekers, *International and Comparative Taxation*, Series on International Taxation, 26 at 30.

392. OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, at 13 (Jul. 10, 2010).

393. *See generally* London/Mexico Models and Commentary.

394. Lorraine Eden, *The Arm's Length Standard in North America*, TAX NOTES INTERNATIONAL 673, 676 (Feb. 2000).

395. *See generally* London/Mexico Models and Commentary.

396. *See* 26 U.S.C. § 482.

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Eventually, this meant that the residual would be assigned wherever senior management wanted it assigned—and, unsurprisingly, in the end this meant it would be assigned to a tax haven.

Thus, the arm's length principle proceeded through three stages in terms of the assignment of the residual. The first, in the 1933-46 period, assigned the residual according to crude, but defensible conceptions of economic allegiance/value creation—to central management in Carroll's view, throughout the group in the view of the London and Mexico models.[397] The second was indeterminate in the assignment of the residual, largely because it elevated the arm's length idea to the status of an end in itself, rather than a subsidiary part of a larger principle.[398] But the third was probably the worst of the three, by making the allocation of the residual voluntary with the taxpayer, meaning that it would be difficult and possibly impossible to ever subject the residual to tax, meaning it would be virtually tax exempt.[399]

And the third system really made a mockery of the very of idea of arm's length, as even some of the most serious defenders of the system are sometimes forced to concede. Where a TNE formed a "central" party in a tax haven, and allocated the residual to it, it was like saying that two unrelated parties who controlled a highly valuable profit situation, who had to arrive at a price which would divide the profits equitably, would resolve their situation by finding a party unrelated to both, and make the sale through the third party at such prices that the substantial portion of the high profit inured to the third party. This was perhaps the one thing independent parties in such a situation would not do.

IV. The Emerging Formulation: Arm's Length From the Guidelines to BEPS

A. Permanent Establishments and the Authorized OECD Approach (AOA)

The 1995 *Transfer Pricing Guidelines* apply explicitly only to the question of allocations among "associated enterprises," governed by Article 9 of the OECD Model Tax Convention.[400] After finalizing those Guidelines in 1995, the OECD turned its attention to the related, though distinct, question of allocations of profit between an enterprise and its permanent establishments abroad.[401] Throughout the first decade of the new century, the OECD issued a series of reports setting forth an "Authorised OECD Approach"

397. Michael Kobetsky, International Taxation of Permanent Establishments 26 (2011).
398. Ramon Dwarkasing, Comments from Academia on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles 12 (2013).
399. Deloitte, *OECD Releases Additional Implementation Guidance on CbC Reporting*, Arm's Length Standard, Aug. 2017, at 23.
400. Org. for Econ. Co-operation and Dev. [OECD], *2010 Report on the Attribution of Profits to Permanent Establishments*, ¶ 3 p. 11 (July 22, 2010).
401. *Id.*

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(AOA) to the question, which culminated in a final Report issued in 2010.[402] The AOA appeared to rest on economic premises different from those which seem to undergird the 1995 Guidelines.[403]

The OECD began by formulating a "Working Hypothesis" (WH), which aimed "to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise could be taken," and "how the guidance in the Guidelines could be applied, by analogy, to attribute profits to a PE in accordance with the arm's length principle."[404] The WH was to be "constrained" by neither "the original intent or by the historical practice and interpretation of Article 7," but rather "the focus was on formulating the most preferable approach . . . given modern-day multinational operations and trade."[405]

The OECD issued a discussion draft for public comment in February 2001, in two parts.[406] Part I tested the WH in general, and Part II its application to the financial sector, "where trading through a PE is widespread."[407] The OECD issued a draft of a new Part III, applicable to global trading,[408] in March 2003, together with a revision of Part II.[409] It issued a revision of Part I, renaming the WH as the AOA, in August 2004, together with revisions of Parts II and III,[410] and issued revised versions of all three parts in December 2006.[411] It issued a draft version of a Part IV, governing insurance, in August 2007.[412] A final Report was issued in July 2008, covering all four parts.[413]

402. *Id.*

403. *Id.*

404. *Id.*

405. *Id.*

406. Org. for Econ. Co-operation and Dev. [OECD], *Discussion Draft on the Attribution of Profits to Permanent Establishments*, 2 (2001).

407. Org. for Econ. Co-operation and Dev. [OECD], *Report on the Attribution of Profits to Permanent Establishments*, 7 (July 17, 2008).

408. Org. for Econ. Co-operation and Dev. [OECD], *Discussion Draft On The Attribution Of Profits To Permanent Establishments: Part III*, 23 (Mar. 4, 2003).

409. Org. for Econ. Co-operation and Dev. [OECD], *Discussion Draft On The Attribution Of Profits To Permanent Establishments: Part II*, 3 (Mar. 4, 2003).

410. Org. for Econ. Co-operation and Dev. [OECD], *Discussion Draft On The Attribution Of Profits To Permanent Establishments: Part I*, 4 (Aug. 4, 2004).

411. Org. for Econ. Co-operation and Dev. [OECD], *Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment: Part IV*. (Aug. 22, 2007).

412. *Id.*

413. OECD, *Report on the Attribution of Profits to Permanent Establishments* ¶ 8, p. 8. (2008) [hereinafter 2008 OECD PE Report]. The 2008 Report stated that Article 7 and its Commentary would be revised in the next update of the Model Convention, then scheduled, and ultimately released, in 2010. The final Report also revised the Commentary to Article 7, effective with the 2008 update on the Model Convention, with respect to matters that did not conflict with the pre-existing commentary. The Report cautioned "taken care, when interpreting bilateral treaties that include the current text of Article 7 . . . to use only the part of the Report that do not conflict with the Article 7 Commentary as so revised."

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The AOA picks up from the Guidelines the three-pronged "functional analysis" of the five-part "comparability analysis" for making allocations identified, if not emphasized by the Guidelines—functions performed, assets used, risks assumed. The signal departure of the AOA from the Guidelines concerns a difference in approach to the "initial" allocation made by the enterprise. Indeed, the discussion in the AOA papers indicates the extent to which, by 2008 if not by 2001, the interpretation and application of the Guidelines had come to be dominated by the tendency described above—of using the "contractual allocation" not as a facet of "comparability," on the one hand, but as a presumptive result and starting point, on the other. The discussion in the AOA virtually assumes this latter technique is the stance of the Guidelines. And it is clear that this method is *not* to be imported to the PE context:

> As between unrelated enterprises, the determination of which enterprise owns assets and which bears risk is determined by legally binding contracts or other ascertainable legal arrangements. Similar considerations apply to associated enterprises providing those contracts or legal arrangements reflect the underlying reality and meet the criteria in Chapter I of the Guidelines. Similarly, in a separate enterprise context no issues generally arise over determining which enterprise possesses the capital. The factual, legal position in a PE context, on the other hand, is that there is no single part of an enterprise which legally 'owns' the assets, assume the risks, possesses the capital or contracts with separate enterprises. The legal position is, thus, unhelpful in a PE context, since Article 7(2) requires the PE to be treated as if it were a distinct and separate enterprise, performing its own functions, assuming its own risk, and owning or using assets on its own. It is, therefore, necessary under the arm's length principle of Article 7 to develop a mechanism for attributing risks, economic ownership of assets [footnote omitted] and capital to the hypothetically distinct and separate PE, for associating with the hypothetically distinct and separate PE the rights and obligations arising out of transactions between separate enterprises and the enterprise of which the PE is a part and for recognising and determining the nature of the dealings' (*i.e.*, the intra-enterprise equivalents of separate enterprise transactions) between the hypothetically distinct and separate PE and other parts of the enterprise of which the PE is a part.[414]

To achieve this task, the final 2008 Report, as proposed by the 2001 Report, devises a novel conception, of "people functions" associated with assets owned or risks assumed:

> As it is not possible to use a legal analysis as the required mechanism, another solution must be sought. After careful considerations, the OECD *decided* that a functional analysis should be used, as this concept

414. 2008 OECD PE Report ¶ 17, pp. 13-14.

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> underpins the application of the arm's length principle under Article 9 and there is already considerable guidance on how to conduct this analysis in the Guidelines. However, in order to address the issues created by the fact that legally the assets, risks, capital, and rights and obligations arising out of transactions with separate enterprises belong to the enterprise as a whole rather than to any one part of the enterprise and the other there is no legal transaction between different parts of a single entity, it proved necessary to supplement the functional analysis of Article 9. Accordingly, the Authorised OECD Approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets [footnote omitted] are performed by people in the PE. The Authorised OECD Approach also sets forth approaches to attribute capital, including 'free' capital (*i.e.* funding that does not give rise to a tax deductible return in the nature of interest), to the PE to support the functions it has performed, the risks assumed and assets attributed to it, as well as criteria for the recognition and characterisation of dealings between the PE and other parts of the enterprise to which it belongs.[415]

This analysis of "people functions" is key to step one of the Article 7 analysis—hypothesizing the PE as a distinct and separate enterprise.[416] Step two—determining the profits attributed to the enterprise so hypothesized—was to be taken by reference to the Guidelines to a considerably greater extent:

> Under the second step of the Authorised OECD Approach the Guidelines are applied by analogy to the PE'S dealings with other parts of the enterprise to ensure that the performance of all of its functions in relation to these dealings is rewarded on an arm's length basis. The dealings of the hypothesised distinct and separate enterprise will be compared to transactions of independent enterprises performing the same or similar functions, using the same or similar assets, assuming the same or similar risks and posing the same or similar economically relevant characteristics. The transfer pricing methods set out in the Guidelines are applied to determine an arm's length price for the dealings. It should be noted that there is no presumption that functions other than significant people functions relevant to the assumption of risk and significant people functions relevant to the economic ownership of assets are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances.[417]

415. *Id.* ¶ 18, p. 14 (emphasis added).
416. *Id.* at 13.
417. *Id.* ¶ 20, p. 15.

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The first salient point about the AOA's discussion, also relevant to the BEPS initiative which follows within a relatively short time, concerns the realism of the contrast that discussion draws between the associated enterprise and permanent establishment contexts. In the first place, it is not an altogether controlling circumstance that "the legal position is thus unhelpful in a PE context," that is, it does not mean that there is no potential *starting point* determined by the enterprise itself which could be used in constructing the "hypothesis" of separateness.[418] Most enterprises keep some form of separate books for their geographically separate branches; certainly banks do. These could be used as analogues of the contractual basis for allocations used by the Guidelines; but the 2008 Report does not so much as mention the possibility, at least in the discussion in the early parts of the Report which draw the supposed distinction between the associated-enterprise and permanent establishment contexts.[419]

In the second place, it is not entirely true that in the context of separately incorporated entities, "the determination of which enterprise owns assets and which bears risk is determined by legally binding contracts or other ascertainable legal arrangements."[420] In a limited range of circumstances, in terms of third party dealings, intercorporate contracts will be determinative of the outcome, but even this has limitations, as the lack of clarity about such circumstances as mandatory consolidation in U.S. bankruptcy law demonstrates. But in a much broader range of circumstances, the intercorporate "dealings" governed by intercorporate contracts concern only the related parties, and have little effect on dealings with parties outside the group. Their principal consequence may be their impact on tax allocations. In these circumstances, the "legally binding" quality of these contracts is a virtual fiction, for the consequences dictated by such contracts can and will be readily waived by the "party" the might insist upon those consequences if the parent corporation deems it in the interest of the group to do so, or they might be incomplete from the start as the example of "nonexclusive" licenses which are nevertheless factually treated as "exclusive" licenses by the group

418. *Id.*

419. Later in the document, in talking about establishing "dealings" between and PE and home office, the Report does acknowledge the possibility. Thus, at ¶ 215, the Report notes that "[a]n analysis of the contractual terms of the transaction is part of the functional and factual analysis and can be used to examine whether the actual conduct of the parties conforms to the terms of the contract and is consistent with the economic principles that govern relationships between independent enterprises," and that "[s]uch an analysis will be even more important in the PE context where any terms between the various parts of the enterprise are not contractually binding." The next paragraph (¶ 216) states that "[t]hus, for example an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities, and benefits would be a useful starting point for the purposes of attributing profits." At ¶ 283, the Report notes that "[a] fixed place of business PE, which is typically an economically distinct business unit, may have its own set of financial accounting records that provide a starting port for the attribution of tax profit for tax purposes."

420. *Id.* at 13.

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may illustrate.[421] For these two reasons, the clear line which the 2008 Report suggests to exist between the separate-incorporation and branch context is seriously overstated by the Report, and economically does not exist in such stark terms.

The implication of this is that OECD's rejection of an enterprise-determined starting point or presumption, on the one hand, in favor of a method *initially* dependent on examination of material economic circumstances is much more a matter of *choice* than of *necessity determined by legal reality*. In other words, the AOA is rejecting the notion that the arm's length method *inherently* depends upon an initial enterprise-controlled circumstance, be it internal bookkeeping or contracts, (and its attendant notion, the "one-sided" methods), and embracing the notion that even the arm's length standard may depend partly or wholly upon an examination of concrete aspects of the various components of the enterprise.

The AOA goes beyond this, however, in positing that material economic circumstances begin the allocation process: the Report also identifies the circumstances that do so—and this resides in its conception, novel in the AOA, of "people functions." "Economic" ownership of an asset is determined by which "part of the enterprise . . . performs the significant people functions relevant to the determination of economic ownership of assets."[422] The Report rejects an approach of "allow[ing] taxpayers simply to nominate which part of the enterprise owns the assets," because such an approach, "though simple and administrable, would potentially provide an incentive for taxpayers to attribute economic ownership . . . in ways that would lead to inappropriate allocations."[423]

But this emphasizes on "people functions" has its own difficulties; first because the Report is not wholly definitive about what the term means, and second because it reintroduces some problems of the arm's length idea that the dominant role of "contractual terms," whatever its faults, does mitigate.[424] With regard to assets, the Report sets forth what one might takes as rules for three classes of assets:

- For "financial assets of financial enterprises, the creation and management of such assets (and their attendant risks) is itself the significant people function relevant to determining the initial economic ownership of the assets . . .";[425]
- "[T]he view was expressed that *place of use* should be the sole criterion for attributing tangible assets to a PE," and "there was a broad consensus among the OECD member countries for applying use as the basis for attributing economic ownership of tangible

421. *See also Vann Hard-Boiled WonderWorld* at 321.

422. 2008 OECD PE Report ¶ 21.

423. *Id.*

424. *See id.* ¶¶ 30–33.

425. 2008 OECD PE Report ¶ 23.

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assets in the absence of circumstances in a particular case that warrant a different view;"[426]

- For intangible assets, "[t]he significant people functions . . . are those which require active decision-making with regard to the taking on and management of individual risk and portfolios of risks associated with the development of intangible property,"[427] and "the key question in determining economic ownership of acquired intangibles is where within the enterprise the significant people functions related to active decision-making relating to the taking on and management of risks are undertaken."[428]

The first question one might ask about "people functions" is, perhaps, which is determinative, the "people" or the "function." For instance, suppose that the home office is in New York and the PE is in Frankfurt. The senior manager of the PE makes a decision to acquire intangible property, but does so while working at the home office in New York. Is the asset then attributable to the home office or the PE? Suppose the decision is made while s/he is in a third place, whether during the course of the officer's employment, or perhaps while s/he is on vacation?

Presumably the part of the enterprise with which the "people" are associated would be the decisive consideration, at least in these circumstances. This gives rise to a second question, of how one associates "people" with parts of the enterprise. Personnel may be no more definitively associated with any given part of the enterprise than are assets, activities, functions, or risks. A third question concerns "decisions" or "management" which involve a number of persons, or perhaps a formal committee or board consisting of persons associated with the PE as well as others associated with the home office (and perhaps still others associated with another PE). It should be apparent that even this concept of "people functions" may frequently require the same sort of allocations as are required by assets, costs, income, or other concepts—and that the AOA Report does not give definitive or clear answers to questions posed by the need to make such allocations.[429]

Also in relation to "risk" and the attribution of risk, the AOA ventures into somewhat new territory, but in doing so it devises notions that will influence its later work, in particular under BEPS Actions eight through ten.[430] Its cardinal principle is that a PE should be considered as assuming any risks 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.[431] It gives the example that "the PE should, generally, be treated as assuming the risks arising from negligence of employees engaged in the function performed by

426. *Id.* ¶ 15.
427. *Id.* ¶ 116.
428. *Id.* ¶ 125.
429. *See id.* ¶¶ 30–36.
430. *See id.*
431. *See supra* note 413, ¶¶ 30–36.

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the PE."[432] The Report stresses that "the significant people functions relevant to the assumption of risks are those which involve active decision-making."[433] The novel notion, derived on the basis of financial industry firms internal "key value drivers," *i.e.*, the "*key entrepreneurial risk-taking functions*," made explicit in the AOA Report and different from earlier conceptions of the situs of "risk," including, seemingly, those reflected in the OECD's Guidelines and the United States regulations, is that risk resides where it is managed, and not where it poses *a threat of loss*.[434] The Report corroborates this with the corresponding notion that "capital follows risk," and not *vice versa*: "the part of the enterprise that performs the significant people functions relevant to the assumption of risks . . . would be attributed the capital necessary to support these risks."[435]

This concept has all the difficulties cited above with respect to the problem of attributing "assets" to components of the enterprise, and has some additional problems. Descriptive literature often enumerates different types of risk which attend business activities. The Report itself does this, listing "inventory risk, credit risk, currency risk, interest rate risk, market risks, product liability and warranty risks, regulatory risk, etc."[436] Lists of this kind are almost always suggested to be non-exhaustive. Moreover, the categories are loosely defined and ordinarily employed principally for analytical purposes.[437] This is true even in the banking area where quantitative rules are prescribed for *some* (credit risk, market risk, operational risk) but not all types of identifiable risk. With the AOA, it is not clear how far one is supposed to go in identifying risks and assigning them to component parts of an enterprise, or how seriously to take a defined category of risk.

Another problem concerns quantification, which arises in connection with AOA Report's provisions concerning the allocation of "free capital," which in turn affects the allocation of interest deductions.[438] The default approach under the Report is a "capital allocation approach."[439] Under this approach, an enterprise's "free capital" is allocated "in accordance with the attribution of assets owned and risks assumed," so that "if the PE has 10% of the enterprise's assets and/or risks it will have attributed to it 10% of the enterprise's 'free' capital."[440] This requires some degree of quantification. In the banking area, credit risk is determined in relation to the amount of a credit exposure, so quantification, though based on sometimes crude assumption, proceeds according to a recognized methodology. Noncredit

432. 2008 OECD PE Report ¶ 97.
433. 2008 OECD PE Report ¶ 28.
434. *Id.* ¶ 77.
435. 2008 OECD PE Report ¶ 29.
436. *Id.* at 31.
437. *See id.*
438. *See id.* at 52.
439. *See id.* at 44, 98–99.
440. 2008 OECD PE Report ¶ 155.

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risks taken into account under capital adequacy rules (operational risk and market risk) are *translated* into equivalents of assets, and thus, generate an increment in required capital, according to specified methods. But other risks, even of a financial institution, are subject to no such ready rules. And there are no parallel rules for any kind of risk in any other kind of business.

This leaves open the question of how risk would be quantified for the purposes of the AOA Report's capital allocation method.[441]

The AOA Report, thus, deviates from previous OECD pronouncements on the arm's length method in three critical respects: in departing from the use of enterprise-determined allocations as starting points; in identifying economic criteria for making allocations in a group (the situs of assets and risks, as determined by "people functions;" and in making a group wide allocation of free capital (and determining interest deductions on that basis). At the same time, however, the AOA Report on other, more visible and simpler, issues retrenches, and expands the reach of arm's length at the expense of historical practice not consistent with the more rigid and extreme conceptions born in the 1990s reform. Three issues reflect this tendency.

First, the Report contrasts a "relevant business activity" and a "functionally separate entity" approach to the attribution of profits to PE.[442] The former represents a form of no-creation-of-income approach, under which the profits attributed to a PE from a particular business activity cannot exceed the total profits of the group from that activity—in other words, that the PE may not be allocated any profit not actually realized by the group; *i.e.*, under this approach there could be, for instance, no attribution/deduction of "notional royalties."[443] The AOA Report rejects such an approach in favor of the "functionally separate entity" approach, which would allow the "creation of income" of this kind in a PE.[444] The "creation of income" approach is historically, as detailed elsewhere, a facet of the regime created by the United States in the 1960s, *viz.* a feature of the modern and radical version of "arm's length."

Second, the Report addresses former article 7(3) of the OECD Model Tax Convention, which could be interpreted as authorizing the remuneration to the home office for services performed for the PE on a pure "cost" basis, without a profit element.[445] The Report rejects such interpretations, and the OECD Model Tax Convention was amended in 2010 to revise the provision and eliminate this possible inference; it concludes that "[a]ll member countries, including those that interpret Article 7(3) as requiring the above-named modifications to the arm's length principle, believe that it would be preferable if Article 7(3) did not result in modifications to the arm's length principle."[446]

441. *See id.*
442. *See id.* at 23–27.
443. *See id.* at 34.
444. *See id.* at 25–27.
445. *See id.* at 57.
446. 2008 OECD PE Report ¶ 290.

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Third, the Report addresses former article 7(4) of the OECD Model Convention, which permitted contracting states "to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts" to continue to do so to the extent it had been "customary" to do so.[447] The AOA Report concluded that

> there was a broad consensus among the member countries that such an apportionment method is not consistent with the guidance on the arm's length principle in the Guidelines, or that it is extremely difficult to ensure that the result of applying that method is in accordance with the arm's length principle and thus that "there was a broad consensus among the member countries that under the Authorised OECD Approach only paragraphs 1, 2, and 3 of Article 7 are needed to determine the attribution of profits to a PE."[448] Article 7(4) was accordingly eliminated by the 2010 amendments to the OECD Model Tax Convention.

These tendencies notwithstanding, the AOA is fundamentally based on rather explicit expressions of the underlying idea of the profit allocation system, *i.e.*, that "significant people functions" or "key entrepreneurial risk-taking functions"—measured from an inside perspective of the firm—are the determinative factors for analyzing internal dealings and the resulting allocation of profits to jurisdictions.

B. Value Creation in the 2010 Revision of Guidelines (Restructuring)

While the AOA took shape, the OECD initiated a parallel project with respect to the related enterprise, as opposed to the permanent establishment, context. The project reflected concerns about the response of business to the structure of the 1995 Guidelines, with their emphasis on contractual allocation of risk, and the contemplation of a central party or "developer" within the group. The concern was that businesses were "restructuring" operations to centralize the FAR characteristics in a single entity, and changing what had been full-fledged distributorships into "limited function" distributorships, primarily for transfer pricing, or tax avoidance purposes.

The restructuring project was instituted in 2005 by a Roundtable with business representatives, and the issue was quite controversial.[449] The conclusion of the Roundtable entailed the formation of a Joint Working Group (JWG) of delegates from Working Party No. 1 and Working Party

447. *Id.*
448. 2008 OECD PE Report ¶ 296.
449. *See* Org. for Econ. Co-operation and Dev. [OECD], *2nd Annual Centre for Tax Policy and Administration Roundtable: Business Restructuring*, (Jan. 26-27, 2005), http://www.oecd.org/ctp/transfer-pricing/2ndannualcentrefortaxpolicyandadministrationroundtablebusinessrestructuring.htm [hereinafter 2005 Roundtable].

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No. 6. These discussions led to a discussion draft issued in 2008,[450] and a final Report in 2010.[451] The final Report was largely incorporated into the revision of the Guidelines in 2010 as a new chapter of the Guidelines.[452]

Although the OECD tried to avoid the impression of transferring the AOA to the related party context,[453] it was a widely held perception that the OECD was experimenting with precisely that after the business community fathomed the possibilities offered by the 1995 Guidelines' emphasis on contractual terms and ownership of intangibles to divorce tax liabilities from the internal value of active business functions. As the OECD put it, it had discerned that "since the mid-90s" the "common pattern" of international business organization regardless of their products or industry sectors was becoming "more centralized" with intangible assets and risks which were "previously integrated in local operations" being transferred to "more centralized and specialized regional or global units" with tax administrations "seeing reduced profits being generated in their jurisdictions as a result."[454] Thus, in 2005, at the "2nd CTPA Roundtable," four years after the basic structure of the AOA was internally agreed upon, the OECD started to prepare the heart surgery operation the 1995 Guidelines' "functional analysis" required.[455]

A variety of questions arose as to how to proceed with respect to such "business restructurings." The first was whether or not asserted business restructurings indeed resulted in "any changes in the functions or activities of the local operations which justify the different tax treatment" taxpayers claimed to result from it, an issue treated by the Roundtable initially as a factual problem, stressing the importance of ascertaining whether the purported changes in risk and/or ownership structures had been actually "agreed on and carried out," which might be difficult to determine.[456]

The second question involved the tax implications of the business restructuring itself, especially the determination if the conversion of a local entity resulted in a transfer of intangible assets and how to measure an "appropriate remuneration" for any such transfer.[457] In particular, the theoretically difficult first part of that question could not be resolved *ad hoc*. But the Roundtable realized that the conversion of a "full fledged distributor

450. *See* OECD, *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment*, at 17, (Sept. 19, 2008–Feb 19, 2009), http://www.oecd.org/tax/transfer-pricing/41346644.pdf [hereinafter 2008 OECD Discussion Draft].

451. *See* OECD, *Report on the Transfer Pricing Aspects of Business Restructurings: Chapter IX of the Transfer Pricing Guidelines*, (July 22, 2010), http://www.oecd.org/tax/transfer-pricing/45690216.pdf [hereinafter 2010 Transfer Pricing Guidelines].

452. *See* OECD, *Revision of the Recommendation of the Council on the Determination of Transfer Pricing Between Associated Enterprises [C(95)126/FINAL]*, (June 29, 2010).

453. 2008 OECD Discussion Draft, *supra* note 450, at 9.

454. 2005 Roundtable, *supra* note 449, at 1.

455. *See id.*; OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, para. 1.28 (July 1995) [hereinafter 1995 OECD Guidelines].

456. 2005 Roundtable, *supra* note 449.

457. *Id.*

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of that establishment."[220] This percentage was to be fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country (Art. VI ¶ 1, lit. C of respective Protocol).[221]

This meant that in cases where uncontrolled prices could not be determined, the application of "separate accounting," in a narrow sense, collapsed. "If the methods of determination described in the preceding sections are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated" (Art. VI para. 1, lit. D of respective Protocol).[222] This was considered typical for situations in which functions were economically integrated and, thus, incomparable to market transactions that a "comparison with the results obtained by similar enterprises operating in that country" was not possible. With regard to the apportionment the commentary, exposing its "value creation" foundation, specified that:

> [A] situation [where apportionment of income will be necessary] arises when a comparison between the nature of the activities and the conditions of operation of the establishment of the foreign enterprise cannot be made with those of full- fledged domestic enterprises. It is provided that, in this case, the method of fractional apportionment may be applied. Under this method, the earnings of each establishment are computed as a proportion of the entire profits of the enterprise to which the establishment belongs, on the basis of the general balance sheet and profit-and-loss account of the enterprise. Such fractional apportionment may be unlimited or limited. In the first case, it takes as its starting-point the total income derived by the enterprise as a whole from all sources. In the second case, reference is made only to that part of the total profits of the enterprise which is derived from transactions in which a part has been taken by the establishment whose share in the total profits is to be determined. It is to this second form of fractional apportionment that recourse may be had according to the Protocol. The share of the total profits from joint transactions that is attributable to the establishment concerned is to be determined by dividing these profits according to the ratio that exists between certain factors pertaining to the establishment concerned and the total of the same factors for the entire enterprise.[223]

Furthermore, in cases where the foregoing rules—*i.e.*, including (limited or unlimited) fractional apportionment—did not result in a "fair allocation" of income, the competent authorities could even consult to agree upon any

220. *Id.*
221. London/Mexico Models *supra* note 206, at 4398.
222. *Id.*
223. *Id.* at 4340.

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slightly changed the scope of the project after the PE threshold issues were referred to Working Party 1 by the CFA, these four Issues Notes addressed:

- the allocation of risks between related parties in an Article 9 context and in particular the interpretation and application of paragraphs 1.26 to 1.29 of the 1995 Guidelines;
- the application of the arm's length principle and the Guidelines to the restructuring itself;
- the "application of the arm's length principle and the Guidelines to post-restructuring arrangements"; and
- "important notions in relation to the 'exceptional circumstances' where a tax administration may consider not recognising a transaction or structure adopted by a taxpayer."[469]

All four Issues Notes have a theoretical core grounded in "value creation" and "transfer of value" arguments, and all were ultimately translated into the four parts of the 2010 final Report and, thus, to Chapter IX of the 2010 revised Guidelines.[470] Nevertheless, we see Issues Note No. one (Part one of Chapter IX) as conceptually[471] the most important and progressive redefinition of how the "arm's length standard" generally operates.[472]

> This Part 1 is based on the premise that an increase in risk-bearing in general open market situations should be compensated by an increase in the returns derived from a particular transaction by the party bearing the risk. This premise is related to the provisions of Chapter I of the Guidelines that the "contractual terms" "generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties."[473]

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may involve cross-border transfers of valuable intangibles. Business restructurings that are within the scope of the OECD's project primarily consist of internal reallocation of functions, assets and risks within an MNE, although relationships with third parties (e.g. suppliers, sub-contractors, customers) may also be a reason for the restructuring and/or be affected by it. *Id.* at 6.

468. *See id.* at 3.

469. *Id.*

470. *See id.*

471. Equally contested by the business community was Issues Note No. 2 that introduced the "profits potential approach" to measure the transferred *value of combined assets* pertaining to relocated functions. The Federal Republic of Germany had unilaterally enacted such an approach to business restructurings as Sec. 1 ¶ 3, sentences 9-12 German Foreign Tax Act (Außensteuergesetz, AStG) through Article 7 of the *Unternehmensteuerreformgesetz 2008*, August 14, 2007, BGBl. I 2007, 1912.

472. While Chapter IX is only applicable to "business restructurings," the OECD saw its analysis and conclusion as being "based on the existing transfer pricing rules." *See* 2008 Discussion Draft, at 8–9. Additionally, the 2008 Draft stated that "[r]isk allocation and risk transfers can also be significant outside business restructurings and, although this first Issues Note was drafted in the context of the business restructurings project and is included in this discussion draft, its scope and significance go beyond business restructurings." *Id.* at 9.

473. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and Transfer Pricing Features of Selected Countries*, at 47 (2010 ed.) [hereinafter 2010 OECD Guidelines]; 1995 OECD Guidelines, *supra* note 455, at ¶ 1.28.

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Issues Note No. 1/Part 1 challenges and circumscribes the deference paid to contractual assignments of risks and the consequential profit attribution—and as such the quasi-elective profit assignment permitted by the Guidelines'—by reference to the notion, set forth in the 2010 revision of Chapter I, that any "contractual allocation of risk between associated enterprises" will be respected only to the extent that it has economic substance.[474] In testing the necessary "substance" of the contractual assignments to be respected, Chapter IX directs attention to three factors collateral to the taxpayers' intracorporate contracts—whether the parties' conduct conforms to the contract; whether the contractual allocation is "arm's length"; and the consequences of the allocation.[475] Of central significance is the second. This means that contractual allocations have necessary "substance" to be respected "where data evidence a similar allocation of risk in" contracts between comparably situated independent parties.[476] But absent such comparables, it becomes necessary to *hypothesize* "whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances."[477] Part 1 describes factors that "can assist" in this hypothetical determination to be

(i) the "control over the risk" contractually allocated; and

(ii) the anticipated "financial capacity to assume that risk."[478]

Chapter IX elaborates a conception of "control over risk" which greatly resembles the parallel concept in the AOA, although Chapter IX never explicitly uses the term "significant people functions":

> "[C]ontrol" should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people—employees or directors—who have the authority to, and effectively do, perform these control functions. Thus, when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that other party.[479]
>
> While it is not necessary to perform the day-to-day monitoring and administration functions in order to control a risk (as it is possible to outsource these functions), in order to control a risk one has to be able to assess the outcome of the day-to-day monitoring and administration functions by the service provider (the level of control needed and the type of performance assessment would depend on the nature of the risk).[480]

474. 2010 OECD Guidelines, *supra* note 473, at 240.
475. *Id.*
476. *Id.* at 241.
477. *Id.* at 242.
478. *Id.*
479. 2010 OECD Guidelines, *supra* note 424, at 243.
480. *Id.*

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Chapter IX accompanies these provisions with significant disclaimers aimed at quelling protests. It says first that "[j]ust because an arrangement between associated enterprises is one not seen between independent parties should not of itself mean the arrangement is non-arm's length."[481] And Chapter IX includes a provision—not set forth in the 2008 Discussion Draft—to calm fears that it is "importing" AOA standards into the Article 9 context:

> The reference to the notions of 'control over risk' and of 'financial capacity to assume the risk' is not intended to set a standard under Article 9 of the OECD Model Tax Convention whereby risks would always follow capital or people functions. The analytical framework under Article 9 is different from the AOA that was developed under Article 7 of the OECD Model Tax Convention.[482]

But, it is difficult to escape the conclusion that by elevating the notion of "control over risks" to a general principle for testing all contractual allocations of risks that cannot be verified by actual open market comparables—*i.e.*, all transaction that are firm specific in nature and not readily found between independent parties—it is transforming the "arm's length principle" from a tool to pricing the transactions "as structured by the associated enterprises"[483] into something of a behavioral standard *based on hypothetical behavior*. This leads to the paradoxical situation that additional (if hypothetical) market analogies are employed to implicitly retreat from a mere "pricing tool" and to establish a profit allocation system cognizant of circumstances in which a business restructuring economically did not change the internal "value creation." In such circumstances, tax administrations would be able *to treat the risks contractually relocated as remaining vested in the local entities' "functional" profile for transfer pricing purposes*.

On balance, much as suggested in the AOA, in Issues Note No. 1/Part 1 the OECD establishes that (entrepreneurial) risks of business operations and the associated "residual profit"[484] cannot be shifted within the MNE group by contract alone but only by shifting underlying active (people) functions pertinent to risk management.[485] Put differently, internal processes of value creation were to trump legal forms even if the contracts *would* rule market allocations of profits. As such, Issues Note No. 1/Part I of Chapter IX *disperses "entrepreneurship" within the firm according to managerial people functions*.[486]

Issues Note No. 2/Part 2 addresses the transfer pricing consequences of the business restructuring itself, and although deprived of its core problem identified by the 2005 Roundtable—the definition and allocation of

481. 2010 OECD Guidelines, *supra* note 424, at 242.
482. *Id.*
483. 1995 OECD Guidelines, *supra* note 455, at ¶ 1.36.
484. 2008 OECD Discussion Draft, *supra* note 450, at 14.
485. *See id.* at 6.
486. *See id.* at 14–20.

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economic ownership of "intangibles" for transfer pricing—the Note contained some noteworthy conceptually new features.[487]

Most decisively, in considering the appropriate, if any, compensation for the restructuring itself, the OECD put *emphasis on internal intangible factors to the firm's economic value generation* regardless of their qualification as "property" or treatment for accounting purposes. Any "transfer of something of value,"[488] the OECD posited, would give rise to a compensation between independent parties. Hence, the precise economic content of the restructuring transaction must be understood on the basis of the "economic principles that generally govern relationships between independent enterprises."[489] Thereby, the first intangible factor to take into account may be "local synergy losses" of the restructured entity, regardless of the potential overall synergy increase of the group as a whole, as a consequence of the restructuring;[490] the second, derived from the "options realistically available" (ORA) concept, might be an indemnification payment for the termination of contracts, again regardless of overall increases in group-wide synergies;[491] the third might be the transfer of a "profit potential" which was defined as "not an asset, but a potential which is carried by some rights or other assets,"[492] if relinquishing it would call for an "appropriate remuneration" on open market terms;[493] the fourth might be a straightforward transfer of "intangibles" previously "owned" by the restructured entity;[494] the fifth intangible factor might be a transfer of "goodwill" associated with bundle of (tangible or intangible) assets used in an activity transferred in the restructuring transaction (*i.e.*, transfer of a going concern).[495]

This set of Guidelines aims to prevent an MNE from voiding higher-tax, satellite jurisdiction of "assets, risks, and functions," transferring them to a, central "cash box," organized in a tax haven or other lower-tax jurisdiction. It achieves this aim by providing that there will be a deemed capital-like transaction to which an "arm's length" charge will be imputed. What is

487. *See id.* at 21-37.

488. *See id.* at 21.

489. *Id.* at 22.

490. *See* 2008 OECD Discussion Draft, *supra* note 450, at 23.

491. *See id.*

492. *Id.* at 24.

493. *See id.* at 25. The practical difficulty of this approach is to determine the difference in net present value of riskier, yet potentially more profitable, and less-risky, yet more stable flows of anticipate profits, necessary to measure the "appropriateness" of any compensation.

494. Issues Note No. 2 did not elaborate the crucial questions how to determine transfer pricing "ownership" and how to determine if there was an actual "transfer" (i.e. a change in "ownership") of intangibles. *See id.* at 28–29. The Issues Note at ¶ 84 only plays with the ORA concept to provide hints how to determine appropriate remuneration if a transfer could be assumed to have taken place. But one noteworthy, yet poorly elaborated, idea pertains to so-called "local intangibles," *i.e.* "intangible assets *that cannot be transferred because they are inherent to the local operation.*" *Id.* at 31.

495. *See id.* at 32.

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United States' balance of payment deficits steadily grew, and, despite the international standing of the dollar, led to a drain on the gold reserves, which by the mid-1960s became quite threatening.[231]

Prior to this development, United States administrations viewed the expansion of United States TNEs as a positive development from the standpoint of United States foreign policy.[232] The Eisenhower Administration had, in keeping with this policy, advocated to reduce the rate of tax on the foreign earnings of the United States TNEs. When the Kennedy Administration came to power in 1961, it had quite different views, in part because it held "center-left" viewpoints more sympathetic to labor, and partly because of the increasing seriousness of the balance of payments problem. The balance of payments problem could have been mitigated by allowing domestic interest rates to rise in relation to foreign (primarily European) interest rates. The Administration opposed such an approach because rising rates could impede domestic growth and employment.[233] The administration was, thus, committed to keep domestic interest rates low in relation to foreign rates—and the rates in question were *after-tax* rates. The corresponding tax policy would be to *tighten* or raise the taxation of the foreign income of United States persons (exported capital), and to *relieve* or lower the taxation of the United States income of foreign persons (imported capital). This is what the administration-sponsored legislation of the period did: the Revenue Act of 1962[234] enacted the "controlled foreign corporation" provisions and its legislative history mandated revision of the transfer pricing rules; the Foreign Investors Tax Act of 1966[235] eliminated most of the "force of attraction" aspects of the taxation of foreign-owned United States businesses and reduced United States taxation of "inbound" investment.[236] And this policy, translated into theory, exhibited an emphasis on *residence* basis taxation generally, and de-emphasis of *source* basis taxation, as a general matter (whether with respect to passive or active income).

The Johnson Administration proposed its new transfer pricing regulations in 1965[237] and 1966,[238] and finalized them in 1968[239] and 1969.[240] The

231. *See id.* 79 – 81.

232. *See generally* Robert Gilpin, U.S. POWER AND THE MULTINATIONAL CORPORATION: THE POLITICAL ECONOMY OF FOREIGN DIRECT INVESTMENT, 115 (1975).

233. *See, e.g.*, President's Special Message on the Balance of Payments I (July 18, 1963), *reprinted in House Comm. on Ways and Means, Legislative History of H.R. 8000*, 88th Cong. (1966), quoted at Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, TAX NOTES, 625, 644 n.183 (1986).

234. *See generally* Pub. L. No. 87-834, 76 Stat. 960 (1962).

235. *See generally* Pub. L. No. 89-809, 80 Stat. 1555 (1966).

236. In this period of the ascendancy of "Keynesian" economics, the Administration's solution to the balance of payments problem was through direct capital controls. The Congress enacted the Interest Equalization Tax Act of 1964 to limit outflows of portfolio capital, and later, the Johnson Administration imposed controls of foreign direct investment in 1968.

237. Allocation of Income and Deductions Among Taxpayers, 30 Fed. Reg. 4256 (proposed Apr. 1, 1965).

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of the comparability analysis taking into account Issues Note No. 1 has to be prevalent in order to apply a "one-sided" method going forward.[506] Neither, the OECD started to stress, can a "one-sided" method be applied on the basis of a "one-sided analysis" without having some regard to "some qualitative, non-financial information" of both parties to the transaction.[507] The application of the two-sided profit split was seen as hinging on the "the nature and extent of the risks and intangibles" that remain with the restructured entity,[508] but because the elaboration of the definition and assignment of "intangibles" in transfer pricing analysis was outsourced this statement ran rather empty. Still, the Issues Note made a tentative step, arguing the profit split method could be appropriate in a wider range of "non-benchmarkable (*e.g.* strategic) functions" performed by the restructured enterprises and not found in market comparables.[509]

These provisions were greatly shortened and softened by the 2010 Report, to the point where they are barely noticeable in one paragraph of the final Chapter IX.[510] Instead, Chapter IX sets forth relatively neutral provisions to the effect that restructured entities should not be treated differently than "limited function" entities which are newly formed as such,[511] subject to qualifications concerning differences in FAR that might be occasioned by the prior existence of a full-fledged entity;[512] and cautioning against comparing profitability pre- and post-restructuring in examining the pricing of post-restructuring transactions.[513]

Lastly, and conceptually significant, Issues Note No. 3/Part III contains a discussion of the allocation or attribution of extra profits due to "location savings," in other words of economic externalities, a question the OECD perceives as "obviously dependent" on what independent parties at arm's length would do.[514] Nonetheless, the Issues Note No. 3/Part III fail to deliver a concrete answer because the question again hinges on whether the "more limited" entity being employed to capture the "location savings" rendered routine or unique service, i.e. whether "the subsidiary . . . has developed a valuable intangible corresponding to its technical know-how" because such "an intangible would need to be taken into account in the determination of the arm's length remuneration."[515]

506. *See id.* at 40, 43.
507. *See id.* at 43.
508. *See id.* at 45.
509. *See id.* at 45–46.
510. 2010 OECD Guidelines, *supra* note 424, at 280.
511. *See id.* at 280-281.
512. *See id.* at 278-80.
513. *See id.* at 283–84.
514. *See* 2008 OECD Discussion Draft, *supra* note 450, at 51.
515. *See id.* at 52. The scope of such difficulties may be underscored by certain differences among the two of us concerning the issue of location savings. One author considers the OECD position on location savings a more or less blatant political move to deter developing countries from seeking to tax the extra profit deriving from the low wage levels in their countries, and seems to insinuate, irrespective of what he may actually think, that the other author is a political

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Finally, Issues Note No. 4/Part IV contains an elaboration of the "as-structured" principle of the 1995 Guidelines and the "exceptional circumstances" for non-recognition, *i.e.* when a transaction structure can be re-characterized by tax authorities for transfer pricing purposes.[516] This may be necessary "where there is a dispute about the fundamental nature of the transaction being examined."[517] In such cases, according to the 1995 Guidelines, non-recognition may be necessary to "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 dealing at arm's length."[518] The 2008

correct coward not to admit as much. But this very other author understands that the negotiations about location savings stem from this very desire (on the part of emerging economies) and its abrogation by the OECD, but thinks that capturing economic externalities through application of a transactional contribution system that looks at the internal value of the entities' contributions to value creation requires a more convincing theoretical underpinning and operationalization within the structure of the transactional system (i) because the location saving seems to adroitly considered a comparability factor that could "destroy" comparability but could not—since it is not an intangible—itself create a basis for a profit split; (ii) because the locational aspects of the OLI paradigm are even more difficult to fathom than the entities' respective contributions through functions performed, and open the door to deem every aspect of any locale—such as the rule of law, network effects or educational levels or opportunities—an "economic location saving" that needs to be evaluated.

516. *See* 1995 Guidelines, at ¶1.36:

> ii) Recognition of the actual transactions undertaken
> 1.36 A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises *as it has been structured by them*, using the applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and ill. In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. (Emphasis added).

517. *See* 2008 OECD Discussion Draft, at ¶ 201.

518. *See* 2008 OECD Discussion Draft, *supra* note 450, at 54.

> 1.37 However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. [. . .] The second circumstance arises where, while the form and substance of the transaction are the same, 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 and the actual structure practically impedes the tax administration from determining an appropriate transfer price. [. . .]
> 1.38 In both sets of circumstances described above, the character of the transaction may derive from the relationship between the parties rather than be

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Discussion Draft included two provisions that appeared to expand the authority of administrations. The first would have permitted tax authorities to "adjust the price or other conditions" of a controlled transaction, even where there was no "dispute about the fundamental nature of the transaction being examined," and thus, "no recognition issue" within the meaning of Chapter I, "where such price or conditions are not arm's length according to guidance provided in other parts of the TP Guidelines."[519] The second provided that where the provisions of Chapter I did apply, "Article 9 would 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 dealing at arm's length," with "the objective . . . to arrive at a characterisation or structure that comports as closely as possible with the facts of the case."[520] Both provisions were omitted by the 2010 final Report and not included in Chapter IX.

As a conceptual matter, both Issues Note No. 4 and Part 4 emphasize the "exceptional" character of such an exercise and the general rule to base any transfer pricing analysis on the transaction "as structured" by the taxpayer.[521] Additionally, the Note stresses that non-recognition is appropriate *only* if the actual transaction cannot be priced appropriately,[522] and argues that a transaction structure lacks "economic rationality" only in a narrow class of cases.[523] Thus, while Issues Note No. 1/Part 1 is quite progressive on assessing the "substance" of a contractual allocation, the OECD did not endorse using the cruder tool of non-recognition in other than "exceptional" cases, yet the precise delineation of the two concepts is not always straightforward.[524]

The four Issues Notes were incorporated into a new Chapter IX and existing Chapter I of the OECD Guidelines, respectively, in 2010.[525] Left

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determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length dealings. Article 9 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 dealing at arm's length. [. .]

1995 OECD Guidelines, *supra* note 3455a, at ¶¶ 1.37–1.38; *see* 2008 OECD Discussion Draft, *supra* note 450, at 54.

519. *See* 2008 OECD Discussion Draft, *supra* note 450, at 54.

520. *See* 2008 OECD Discussion Draft, at ¶ 202.

521. *See* 2010 OECD Guidelines, *supra* note 424, at 280.

522. *See* OECD, *Chapter IX of the Transfer Pricing Guidelines*, ¶ 9.180 (July 22, 2010) [hereinafter OECD Chapter IX of the Transfer Pricing Guidelines].

523. *See id.* ¶ 9.171.

524. *See also* OECD, *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment*, ¶ 217 (Sept. 19, 2008–Feb. 19, 2009) (The example pertains to a transfer of a non-routine intangible asset to an entity not having the people to actively manage the intangible going forward for a lump-sum; a transaction structure, the Issues Note states, most OECD countries "indicate they would not recognize.").

525. OECD Chapter IX of the Transfer Pricing Guidelines, *supra* note 522.

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unresolved was the problem of defining and assigning economic ownership of "intangibles" for transfer pricing purposes, one major problem initially identified by the 2005 Roundtable as part of the question how to apply the arm's-length standard to the restructuring itself (Issues Note 2),[526] but the OECD continued its work on this critically important issue.

C. The 2012 Intangibles Report

In 2010, with the publication of the revisions of the OECD Model Convention and the Transfer Pricing Guidelines, the OECD announced that it would study the question of identifying the "economic owner" of "intangible property" within an integrated corporate group.[527] The problem had been identified as a significant one in the discussions at the 2005 Roundtable with which the studies leading to the restructuring report and Chapter IX had been instituted, but the OECD working parties had agreed to excise the issue from the restructuring project.[528]

The question derived from the concept of the "developer/assister" rule, which was descended from the original United States 1968 regulations.[529] Under this rule, in the absence of a "bona fide" cost-sharing agreement, one entity within a group was identified as the "developer" of an intangible, ordinarily the party that bore the greatest share of the costs and risks of development. Other components of the group participating in the development were "assisters."[530] The key to the rule was that no allocations were made with respect to the development activity at the time of that activity, but rather were deferred until the time the development of any intangible was completed, and the intangible was put into service.[531] If there were a bona fide cost sharing agreement in place, then costs would be allocated under that agreement, and the benefits conferred by that agreement would govern the allocation of income derived from the completed intangibles.[532]

These concepts or rules played an obvious role in facilitating the "cash box" practice because the TNE entity could concentrate charges incurred in the development of the intangible in the cash-box entity, rendering it the "developer." This could then justify allocation of the lion's share of the

526. *Id.* ¶ 78 (Issues Note No. 2 only contained the statement that an "essential part of the analysis of a business restructuring is to identify what intangible assets if any were owned by the restructured entity, what intangible assets if any were actually transferred, and what their value is.").

527. *See also* OECD, *Transfer Pricing and Intangibles: Scope of the OECD Project* (Jan. 25, 2011), http://www.oecd.org/tax/transfer-pricing/46987988.pdf.

528. *Id.* ¶1.

529. 33 Fed. Reg. 5848 (Apr. 15, 1968).

530. *Id.*

531. *Id.*

532. *Id.*

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"residual" income to this entity, whether under a bona fide cost sharing agreement or otherwise.[533]

The OECD issued a public Discussion Draft with respect to the intangibles issue in 2012.[534] In a prefatory note, Working Party No. 6 made clear its principal objective was reform of this "developer/assister" idea, saying that its "delegates are uniformly of the view that transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties," and that that "neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more."[535] The Discussion Draft was to accomplish this by "identif[ying] a concept of intangible related returns and suggest[ing] that such returns should follow the contributions to the value of the intangibles."[536]

The Draft sketches an allocation system for "intangible related returns" (IRR) that asks which "member or members of an MNE group . . . are entitled to intangible related returns in arm's length transactions."[537] The IRR attributable to a particular intangible is defined as the net "economic return from business operations involving the use of that intangible after deducting (i) the costs and expenses related to the relevant business operations; and (ii) returns to business functions, assets other than the particular intangible in question, and risks, taking into account appropriate comparability adjustments."[538] This demoted traditional arm's length pricing by "delineation" of an internal, intra-group transaction, and elevated an approach based on directly reaching results.[539]

The Discussion Draft indicated that the determination which member/s of the groups is/are "entitled" to IRR was not to be controlled by "formal" consideration.[540] The terms and conditions of legal arrangements including relevant registrations, license agreements, and other relevant contracts would form the starting point of the analysis, but it is necessary to ascertain "whether the functions performed, the assets used, the risks assumed, and the costs incurred by members of the MNE group . . . are in alignment with

533. *See also* James R. Mogle, *The Future of Transfer Pricing: Practical and Policy Opportunities Unique to Intellectual Property, Economic Substance, and Entrepreneurial Risk in the Allocation of Intangible Income*, 10 GEO. MASON L. REV. 925 (2002).
534. OECD, *Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* (June 6, 2012-Sept. 14, 2012), https://www.oecd.org/ctp/transfer-pricing/50526258.pdf.
535. *Id.* at 12.
536. *Id.*
537. *Id.* ¶ 27.
538. *Id.* ¶ 28.
539. *See also* Joint Comm. on Taxation, 111th Cong., *Present Law and Background Related to Possible Income Shifting and Transfer Pricing*, JCX-37-10, at 13–14, 105 (2010).
540. OECD, *Discussion Draft, Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* (June 6, 2012–Sept. 14, 2012), https://www.oecd.org/ctp/transfer-pricing/50526258.pdf.

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the allocation of entitlement to intangible related returns in the relevant registrations and contracts;"[541] such member/s would be called the "developer/s" in the nomenclature of the 1994 U.S. Regulations, but in the 2012 Draft there can be more than one "developer," and that the Draft did not assign "economic ownership" of the intangible but the right to participate in the IRR, which would generally follow from economic transfer pricing ownership.[542] The analysis under the 2012 Draft would further ask "whether services rendered . . . by other members of the MNE group to the member/s of the MNE group entitled to intangible related returns under the relevant registrations and contracts, are compensated on an arm's length basis."[543] The 2012 Discussion Draft framed the test whether contractual agreements evince the necessary economic "substance" to be respected, stating that:

> When *evaluating the alignment between a contractual claim to entitlement* to all or part of the intangible related returns attributable to an intangible, *and the conduct of the parties*, examination of functions, risks, and costs related to the development, enhancement, maintenance and protection of the intangibles is necessary. Where the conduct of the parties is not aligned with the terms of legal registrations and contracts, it may be appropriate to *allocate all or part of the intangible related returns* to the entity or entities that, *as a matter of substance*, perform the functions, bear the risks, and bear the costs that relate to development, enhancement, maintenance and protection of the intangibles.[544]

The OECD did not develop these concepts further under this Discussion Draft, but its essential approach was carried forward by the work done in connection with the base erosion and profit shifting initiative, as discussed below.

D. Summary of Findings on Validity of the Paradigm

The foregoing review of the evolution of transfer pricing rules demonstrates that the concept of value creation has, since the founding of the international tax system in the 1920s, been the implicit, and at times the explicit, principle governing the assignment of the right to tax business profits.

The system has undergone three major transformations, all assumed under the rubric of the "arm's length principle," which have obscured, but not eviscerated, the role played by value creation, and all of which have varied the treatment of the "residual" income of a TNE group by the

541. *See id.* ¶ 29.
542. OECD, Discussion Draft, *Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* (June 6, 2012–Sept. 14, 2012), http://www.oecd.org/tax/transfer-pricing/46987988.pdf.
543. *See id.* ¶ 29.
544. *See id.* ¶ 37.

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international rules. The first was the original articulation of the "arm's length" idea by Mitchell Carroll on behalf of the League of Nations in the 1930s, which assigned the right to tax the residual to the home country. Although this limited source taxation of business profits, it did so in the name of an idea that embodied value creation—that the central management of the enterprise, headquartered in the parent's home country was the primary generative source of the value the residual represented.

The second was the articulation of the "method" system, describing the "one-sided" methods, by the United States in the 1960s, adopted by the OECD in 1979. This system took the residual away from any necessary assignment to the home enterprise, but left it indefinitely assigned. This created difficulties for tax administrations in determining outcomes, creating the need for *ad hoc* resolutions embodied in the various informal "profit split" methods used under this second regime, and further diminished any emphasis on "value creation."

The third phase was the system adopted by the United States in the early 1990s, and accepted by the OECD, with modifications, in the mid-1990s. This system depended upon "comparability factors," of which the most prominent were the taxpayer's own "contractual allocations." This system left the residual to be assigned to whichever jurisdiction the taxpayer chose; predictably, the taxpayers devised ways of placing the residual in low-tax jurisdictions, often through separate corporate entities created largely to be repositories of the residuals as determined under unilaterally designed intercompany contracts. But even as it permitted this result, the system restored the notion of "value creation," with its supposed emphasis on the locus of "functions," "assets," and "risks," however nebulously those notions were defined. Moreover, the system of taxpayer control quickly proved problematic, if acceptable, at least to the OECD, which in short order began searching for ways to limit taxpayer discretion. That search led ultimately to BEPS, and Action 8-10, but even then, as noted below, there was a reaction demanding at least some restoration of the taxpayer-determined "contractual allocation" regime.

These shifts in the rules reflect the political pressures of the day—the dominance of imperial powers and "capital exporters" in the 1920s and 1930s; the balancing of exchange stabilization against policies promoting economic growth in the 1960s; the dawning of the age of "globalization" in the 1990s. In these developments, value creation has been used in a strictly "transactional" approach that regularly recharacterises the value of contributions to transactions by applying market analogies to measure the value of internalized functions, although this was not and is not foreordained by the basic premise of taxing business income at source. Thus, while arguing that "value creation" represents the true norm implicit in the basic foundation of taxing businesses "at source," we are aware that in practical negotiations on the surface political instincts and interests prevail. Nevertheless, these instincts and concerns are manifestations of the "true" norm. Although its interpretation has changed over time according to

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political pressures and the contemporaneous state-of-the-art, the underlying principle has been consistently value creation. Income allocation might, thus, be seen as an attempt to capture value creation, and "aligning transfer pricing outcomes" might be seen as an appropriate formulation of the "true international norm." As such, we see "value creation" grounded in Article 9 of the OECD Model Convention, and attempts to capture the true value creation as covered by treaty provisions based on it.

At the same time, it is demonstrable that conceptions of how to localize "value creation" have proven very difficult to formulate, and what serve now as such conceptions are still in a primitive state. This has proven the Achille's heel of proposals, for instance, for formula apportionment, as proponents of such a system have consistently been unable to provide convincing answers to what should be the "allocation keys" of such a system. Even the more limited "transactional" profit split methods authorized by OECD materials at the present time suffer this flaw, and the answers given by the BEPS initiative are hardly wholly satisfactory either. Nevertheless, even if "value creation" is not fully theoretically understood, there is a rather solid basis regarding the parameters that contribute to it and thus should be appropriately captured. This should be done not only to create coherence and global acceptability of the system (which contributes to international stability), but also to strengthen the attempts to curtail "artificial" schemes that exploit misalignments between the internal economic value creation and the international tax system; *i.e.*, in the notion of "value creation" theoretical coherence and policy considerations seem to merge.

But this does counsel against extreme statements either way in respect of the BEPS project. It is not fair to argue that "the desired outcome of better 'align[ing] rights to tax with economic activity' constitutes a departure from the current regime," or that "[p]ut simply, the international tax system does not currently allocate taxing rights to countries according to where 'economic activity' takes place;" still less that the BEPS project "overlays a new and completely different principle onto the existing structure."[545] The fact is that the system, with respect to business profits, essays consistently to do this, and employs the touchstone of source as a proxy of "economic activity." Neither, however, is it realistic to assert that "the principle of ensuring that the transfer-pricing outcome be 'in line with value creation'" is "clear and it should be widely perceived as fair, and thus, legitimate."[546] Clarity and legitimacy depend upon considerable further work on the definition of the link of value creation to the economic activities within several jurisdictions involved in the commercial undertakings at issue.

545. Michael Devereux & John Vella, *Are We Heading Towards a Corporate Tax System Fit for the 21st Century?*, 35 FISCAL STUD. 449, 464 (2014).
546. Yariv Brauner, *What the BEPS*, 16 FLA. TAX REV. 55, 99 (2014).

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V. BEPS: Hybrids and Schizophrenia

A. The Deliverables and Discussion Drafts

The OECD issued two principal and five secondary preliminary reports under Action 8 through 10. The OECD issued the "2014 deliverable" under Action 8, the first of the two principal Reports, in September 2014.[547] This was followed by the first of the secondary Reports, on low value-adding intra-group services, in November 2014.[548] In December 2014, the OECD released the second principal preliminary Report, concerning risk, re-characterisation, and special measures under Action 10;[549] and simultaneously released two of the subsidiary Reports, concerning profit splits[550] and cross-border commodity transactions.[551] It released the two other secondary Reports, concerning cost contributions agreements (CCAs)[552] and hard-to-value intangibles[553] in April and June of 2016, respectively. It revised the preliminary guidance on profit splits in July 2016.[554] The final Reports, covering all six topics except the final guidance on profit splits, were issued in September 2015.[555]

As noted above, the OECD in these documents approached its task as confined by two constraints: the first, to strengthen the existing transfer pricing rules to circumscribe tax avoidance; the second, to preserve the "arm's length" system. The OECD resolved the dilemma posed by

547. OECD, *Guidance on Transfer Pricing Aspects of Intangibles* (2014), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#.WQOiXoWcGUk.

548. OECD, *BEPS Action 10: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services* (Nov. 3 2014–Jan. 14, 2015), https://www.oecd.org/tax/transfer-pricing/discussion-draft-action-10-low-value-adding-intra-group-services.pdf.

549. OECD, *BEPS Action 8, 9, 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines* (Dec. 1, 2014–Feb. 6, 2015), http://www.oecd.org/ctp/transfer-pricing/discussion-draft-actions-8-9-10-chapter-1-TP-Guidelines-risk-recharacterisation-special-measures.pdf [hereinafter OECD BEPS Action 8, 9, 10].

550. OECD, *BEPS Action, 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* (Dec. 16, 2014–Feb. 6, 2015), http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-profit-splits-global-value-chains.pdf.

551. OECD, *BEPS Action 10: Transfer Pricing Aspects of Cross-Border Commodity Transactions* (Feb. 10, 2015), https://www.oecd.org/tax/transfer-pricing/public-comments-action-10-cross-border-commodity-transactions.pdf.

552. OECD, *Preliminary Discussion Draft, BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contributions Agreements (CCAs)*, http://www.oecd.org/tax/transfer-pricing/discussion-draft-BEPS-action-8-cost-contribution-arrangements.pdf.

553. OECD, *BEPS Action 8: Hard-to-Value Intangibles* (June 4–18, 2016), https://www.oecd.org/ctp/transfer-pricing/discussion-draft-beps-action-8-hard-to-value-intangibles.pdf.

554. OECD, *BEPS Action 8-10: Revised Guidance on Profit Splits* (July 4, 2016–Sept. 5, 2016), https://www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-revised-guidance-on-profit-splits.pdf.

555. OECD, *Aligning Transfer Pricing Outcomes with Value Creation* (2015), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#.WQOiXoWcGUk.

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focusing, as to the first objective, all but exclusively on what had preoccupied it throughout the previous decade, *viz.*, the problem of TNEs' accumulation of profits in tax haven subsidiaries on the basis of "contractual allocations" or "risks" and placement of legal ownership of intangibles in such subsidiaries.

1. *Intangibles*

Action 8 directed the OECD to "[d]evelop rules to prevent BEPS by moving intangibles among group members," which it said would involve four things:

- adopting a broad and clearly delineated definition of intangibles;
- ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;
- developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and
- updating the guidance on cost contribution arrangements.[556]

The focus of the 2014 intangibles deliverable was upon the first and second items. The 2014 intangibles deliverable sets forth a distinct idea for reformulating pre-existing rules. The focus of the effort was to contrast rules based upon the locus of "value creation" with older (putative) rules that emphasized the situs of "legal ownership." The deliverable's restatement of Chapter VI begins with an extensive description of the task of "identifying" intangible property for purposes of any "transfer pricing analysis," in keeping with the first matter to which Action 8 directs attention.[557] The deliverable sets forth a relatively broad identification of what constitute "intangibles," which the deliverables gives 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."[558] The deliverable rejects focus upon legal or accounting conceptions, rejects any requirement that the property enjoy legal protection, and, while it requires that the item susceptible of being "owned or controlled," and implicitly subject to "use or transfer," it rejects any requirement that the "something" be separately transferable, thus including items that may be transferable "only in combination with other business assets."[559] The deliverable specifically rejects any notion that "market conditions" constitute any kind of intangible.[560] The Report stresses that the process of identifying an intangible is distinct from the

556. OECD, *Guidance on Transfer Pricing Aspects of Intangibles*, at 9 (2014), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#.We-H5denE2w [hereinafter OECD Guidance on Transfer Pricing Aspects of Intangibles].
557. *Id.* ¶ 6.5.
558. *Id.* ¶ 6.06.
559. *Id.* ¶¶ 6.06-.09.
560. *Id.* ¶¶ 6.9, 6.30[viii].

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process of determining a price for its transfer; and emphasizes that intangibles must be identified "with specificity."[561]

The 2014 intangibles deliverable represented a tightening of the "arm's length" rules, particularly with respect to the "cash box" practices, in two principal respects. The key device by which the deliverable proposes to align allocations with "value creation" involves, in essence, the OECD doubling down on "comminution of income." This involves the distinction it draws between two categories of what it characterizes as "transactions": transactions "involving the development, enhancement, maintenance, protection and exploitation of intangibles," on the one hand; and "transactions involving the use or transfer of intangibles," on the other.[562] Both categories are of intercompany "transactions." The second category is further subdivided into two categories: transactions "involving transfers of intangibles or rights in intangiblesl;"[563] and transactions "involving the use of intangibles in connection with sales of goods or performance of services."[564]

It is by means of the first category—of (hypothetical or constructed) transactions "involving the development, enhancement, maintenance, protection and exploitation of intangibles"—that the deliverable diminishes the significance of the criterion of "legal ownership" of the intangible. The deliverable says that "the determination of the entity or entities within an MNE group which are ultimately entitled to share in the returns derived by the group from exploiting intangibles is crucial," but that "[a]lthough the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the legal owner's MNE group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible," and that such members "must be compensated for their contributions under the arm's length principle."[565] The Report lists (familiar) reasons why the determination of what contributions have been made and how to compensate them may be "highly challenging,"[566] and outlines the "steps" to be taken in making such determinations. The fourth and fifth steps listed are new in "arm's length" lexicology, not reflected either in the existing OECD Guidelines or the United States regulations; and these are the essential elements of the deliverable's double down on "comminution":

> (iv) identifying the controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of intangibles in light of the legal ownership of the intangibles under relevant registrations and contracts, and the conduct of the parties, including

561. *Id.* ¶¶ 6.10.
562. OECD Guidance on Transfer Pricing Aspects of Intangibles, *supra* note 556, ¶ 6.84.
563. *Id.* ¶ 6.85.
564. *Id.* ¶ 6.101.
565. *Id.* ¶ 6.32.
566. *Id.* ¶ 6.33.

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> their relevant contributions of functions, assets, risks and other factors contributing to the creation of value;
> (v) where possible, determining arm's-length prices for these transactions consistent with each party's contributions of functions performed, assets used, and risks assumed.[567]

The Report, thus, implies a definition of the "creation of value" as attributable "functions performed," "assets used," or "risks assumed" in connection with "the development, enhancement, maintenance, protection and exploitation of" the intangible. Thus, it mandates a second level of construction of transactions in connection with intangible property: one must not only construct an intercompany transfer for the use in imputing a price to the intercompany transfer of the completed intangible, one must also construct prior intercompany transactions where functions are performed, assets used, or risks assumed by various components of the group, in the process of developing, protecting, or exploiting the intangible.

This is bound to be a complex process, at the least, heaped on top of already complex and indeterminate processes mandated by existing regulations and Guidelines. But apart from its sheer Ptolemaic complexity, the effort to move from emphasis on "formal" ownership to "substantive" value creation fails for three reasons.

The 2014 intangibles deliverable is itself somewhat ambivalent about the move. Its ambivalence is expressed principally with respect to what it defines as the "6.56 functions," the importance of which the deliverable stresses throughout:

> 6.56 In considering the arm's length compensation for functional contributions of various members of the MNE group, certain important functions will have special significance. The nature of these important functions in any specific case will depend on the facts and circumstances. For self-developed intangibles, or for self-developed or acquired intangibles that serve as a platform for further development activities, these more important functions may include, among others, design and control of research and marketing programs, direction of and establishing priorities for creative undertakings including determining the course of 'blue-sky' research, control over strategic decisions regarding intangible development programs, and management and control of budgets. For any intangible (*i.e.* for either self-developed or acquired intangibles), other important functions may also include 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. Those important functions usually make a significant contribution to intangible value, and if those important functions are outsourced by the legal owner in transactions between associated

567. *Id.* ¶ 6.34.

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> enterprises, the performance of those functions should be compensated with an appropriate share of the returns derived by the MNE group from the exploitation of intangibles.[568]

The second broad manner in which the 2014 intangibles deliverable suggests some retreat from the perceived abuses of the 1990s system was by suggesting both a limitation on the use of "one-sided" methods where unique intangibles are involved, and at the same time, a broadened use of the profit split method. Its disfavor of the "one-sided methods" is somewhat buried in the text, but occurs at a number of points in the discussion of the transfer pricing methods applicable in determining the price on an intercompany transfer or license of a defined intangible. These passages are as follows:

> 6.108. In applying the principles of the Guidelines related to the content and process of a comparability analysis to a transaction involving intangibles, a transfer pricing analysis must consider the options realistically available to each of the parties to the transaction. In considering the realistically available options of the parties to a transaction, the principles of paragraphs 9.59–9.64 should be applied.[569]
>
> 6.109 In considering the options realistically available to the parties, the perspectives of each of the parties to the transaction must be considered. A comparability analysis focusing only on one side of a transaction generally does not provide a sufficient basis for evaluating a transaction involving intangibles (including in those situations for which a one-sided transfer pricing method is ultimately determined).[570]
>
> * * * *
>
> 6.130 This Chapter makes it clear that in matters involving the transfer of intangibles or rights in intangibles it is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should take into account all of the relevant

568. *Id.* ¶ 6.56.
569. OECD Guidance on Transfer Pricing Aspects of Intangibles, *supra* note 556, ¶ 6.108.
570. *Id.* ¶ 6.109.

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> factors materially contributing to the creation of value, not only intangibles and routine functions.[571]
>
> * * * *
>
> 6.138 Care should be used, in applying certain of the OECD transfer pricing methods in a matter involving the transfer of intangibles or rights in intangibles. *One-sided methods*, including the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles. In some circumstances such mechanisms can be utilized to indirectly value intangibles by determining values for some functions using those methods and deriving a residual value for intangibles. But, the principles of paragraph 6.130 are important when following such approaches and care should be exercised to ensure that all functions, risks, assets, and other factors contributing to the generation of income are properly identified and evaluated.
>
> 6.139 The use of transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development is generally discouraged. There rarely is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, transfer-pricing methods based on the cost of intangible development should usually be avoided.[572]

The 2014 intangibles deliverable at the same time suggest a greater role for the profit split method. It does so in a bracketed portion of the report—meaning it was subject to further consideration, particularly in connection with later deliverables on Actions 9 and 10—which covers the use of profit split methods both in connection with transfers and licenses of intangible property by one group member to another,[573] as well as in its observation (noted more fully below) that so-called "one-sided" methods should not be used in transactions involving unique intangibles,[574] and its direction that the presence of value in "embedded" intangibles should be taken into account as a comparability factor, rather than a separate transaction.

2. *Re-characterisation*

The 2014 deliverable on "re-characterisation" and "special measures"[575] made inroads on the transfer pricing analysis underlying the "Dutch sandwich"/cash box practices in three principal ways. The deliverable completely restated Section D of Part I of the Guidelines, the section that had detailed the "comparability factors." The revision retained the notion that "a 'comparability analysis' is at the heart of the application of the arm's

571. *Id.* ¶ 6.130.
572. *Id.* ¶¶ 6.138-139.
573. *Id.* ¶¶ 6.145-6.149.
574. *Id.* ¶ 6.109.
575. OECD BEPS Action 8, 9, 10, *supra* note 549.

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method (including comparable uncontrolled transactions) so long as only a single method was used (and a single profit indicator if the comparable profits method was used).[296] Thus, the range could be constructed with measures other than comparable profits. The range could be constructed by the taxpayer in defence of its allocation; a price would be upheld if it generated results anywhere along the range.[297] Gone was the authority of the government to place the price at any "most appropriate" point.

But most importantly, instead of the notion of inexact comparables and in continuing recognition of the problem of comparability, the 1993 temporary regulations introduced an elaborate set of rules for determining when an uncontrolled transaction was comparable to the controlled situation under examination.[298] Comparability was to be determined with respect to five sets of circumstances: functions, risks, contractual terms, economic conditions, and additional factors.[299]

In 1993, the OECD issued a second Report of its Task Force with respect to the revised 1993 regulations.[300] This Report expressed satisfaction with changes made by the revised proposals, particularly with respect to the introduction of the "best method" rule, and the elimination of the use of the CPM as a mandatory check on all other methods.[301] But the second Report also set forth a series of concerns set forth in the first 1993 Report, which it said were continuing with respect to the revisions, as well as a set of new concerns prompted by the revisions.[302] Most of the continuing concerns focused upon the CPM, with the Task Force arguing that its relaxed standards of comparability be clarified, if not narrowed, that a clearer preference for the transactional methods be expressed, and that the CPM be confined to abusive cases.[303] The Report continued to express concern that periodic adjustments might not be compatible with the arm's length standard and voiced reservations about the use of information not available to the parties *ex ante* in making adjustments.[304] The Report also expressed the view that, especially in constructing an arm's length range, the

296. Temp. Reg. § 1.482-1T(d)(2). The provision is carried forward in the final regulations, in force today, Treas. Regs. § 1.482-1T(e).
297. Temp. Treas. Reg. §1.482, 58 Fed. Reg. 5263, 5267 (1993).
298. *Id.* at 5266.
299. Temp. Reg. § 1.482-1T(c)(3)(i)-(v). These are carried forward in the final regulations, in force today, which describe them as "functional analysis;" "contractual terms;" "risks;" "economic conditions;" and the character of the "property or services" subject to the examined transactions. Treas. Reg. § 1.482-1T(d)(3)(i)-(v). The 1993 proposed regulations set forth no provisions concerning cost-sharing arrangements. The Treasury withdrew all provisions of the 1992 proposed regulations *except* those governing cost-sharing. The simultaneously issued temporary regulations, however, did not include the provisions of the 1992 proposed regulations governing cost-sharing, but instead simply included, as Temp. Reg. § 1.482-7T, the text of the provisions of the 1968 regulations (Treas. Reg. § 1.482-2A(d)(4)).
300. 1993 OECD Letter, *supra* note 286.
301. *Id.*¶¶ 2.7, 2.11.
302. *Id.* ¶ 2.4
303. *Id.*¶¶ 2.19-2.22.
304. *Id.* ¶¶ 2.23-2.33.

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> terms of the transactions "would need to be deduced from the conduct of the parties."[581]

This emphasis on examining "actual conduct" to review "contractual terms," together with the emphasis on a two-step process as a counter to the degeneration of the system into one wholly defined by the taxpayer's unilaterally determined contracts, represents the first way in which the recharacterisation deliverable retreated from the severity of the 1990s system. Also, the deliverable listed the old "comparability factors," but various called them "economically relevant characteristics" as well as "comparability factors."

The second manner in which the deliverable tightened the rules governing the "comminution" of income was to expand the provisions of the second governing "risk." In the 2008/2010 business restructuring reports, the OECD had elaborated notions of "risk" and "control of risk" as the elements that were transferred from "complex" distributor entities to a "cash box" entity, as defining the "restructurings" that were the targets of that report.[582] The 2014 recharacterisation directive imports these concepts of "risk" and "control" into the general Transfer Pricing Guidelines, emphasizing the locus of "risk" in the MNE group as a determinant of allocations of income.[583]

The third manner in which the deliverable tightens the transfer pricing rules was its provisions on "non-recognition" of intercorporate transactions. Non-recognition depends upon "[t]he concept of the fundamental economic attributes of arrangements between unrelated parties," and "the test of commercial rationality," which "requires consideration of whether the actual arrangements differ from those which would have been adopted by independent parties behaving in a commercially rational manner."[584] If an "actual arrangement, viewed in its entirety, would not afford such an opportunity to each of the parties, or would afford it to only one of them," the transaction is not recognized.[585] If the transaction is not recognized, then the taxpayer's "structure" should be "replaced" by a structure "determined by the alternative transaction that affords the parties the opportunity to enhance or protect their commercial or financial position," which should be "guided by the fundamental economic attributes of arrangements between unrelated parties," and should "comport as closely as possible with the commercial reality of independent parties in similar circumstances."[586] These provisions are hardly clear, but they do convey the sense of additional authority for tax administrations.

581. *Id.* ¶¶ 7-8.
582. *See* 2008 OECD Discussion Draft, *supra* note 450; *see also* 2010 Transfer Pricing Guidelines, *supra* note 451.
583. 2014 Intangibles Deliverable, *supra* note 556.
584. *Id.* ¶ 88.
585. *Id.* ¶ 89.
586. *Id.* ¶ 93.

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encompasses broader societal considerations and is more future oriented.[31] Nonetheless, the terms have been used interchangeably.

The Union of International Associations ("UIA"), another international bar association, established its International Centre for Corporate Social Responsibility ("ICCSR") in 2002, with an expressed aim to "[e]ngage in teaching and research in the area of corporate social responsibility, drawing the attention of business to community involvement, socially responsible products and processes, and socially responsible employee relations."[32]

B. The Statutory and Regulatory Response

Certain legislation now imposes hard law obligations regarding certain elements of the UNGP, particularly those requiring businesses to self-evaluate and report.

1. *United States*

Two significant legislative regimes address corporate social responsibility. The Dodd-Frank Wall Street Reform and Consumer Protection Act,[33] enacted in 2010, has two reporting provisions that seek to at least have companies identify violations of human rights in two specific areas. Section 1502 of the Act amended Section 13 of the Securities Exchange Act of 1934, to call for regulations requiring annual disclosures as to conflict minerals, to require:

> (i) a description of the measures taken by the person to exercise due diligence on the source and chain of custody of such minerals, which measures shall include an independent private sector audit of such report submitted through the Commission that is conducted in accordance with standards established by the Comptroller General of the United States, in accordance with rules promulgated by the Commission, in consultation with the Secretary of State; and
>
> (ii) a description of the products manufactured or contracted to be manufactured that are not DRC conflict free ("DRC conflict free" is defined to mean the products that do not contain minerals that directly or indirectly finance or benefit armed groups in the Democratic Republic of the Congo or an adjoining country), the entity that conducted the independent private sector audit in accordance with clause (i), the facilities used to process the conflict minerals, the country

31. Dr. Rupert J. Baumgartner & Daniela Ebner, *The Relationship Between Sustainable Development and Corporate Social Responsibility*, http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.485.5912&rep=rep1&type=pdf (last visited Feb. 5, 2018).

32. *International Centre for Corporate Social Responsibility (ICCSR)*, Union of International Associations, https://uia.org/s/or/en/1100000253. (last visited Feb. 5, 2018).

33. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §1502-1504, 124 Stat. 1376 (2010).

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in determining the appropriateness of the *ex ante* pricing arrangements."[592] The deliverable set forth certain caveats: it said "the consideration of *ex post* evidence should be based on a determination that such evidence is necessary to be taken into account when and in so far as there is no other information to assess the reliability of the information on which *ex ante* pricing has been based,"[593] and it said that "[i]n order to ensure that this approach is applied only in situations where the difference between *ex post* outcomes and *ex ante* projections is significant, and where such a difference is due to developments or events that were or should have been foreseeable at the time of the transaction, its application should be subject to the exceptions set out in the following paragraph 14."[594]

The deliverable states four circumstances that might be "exhibited" by HTVIs:

- Intangibles that are only partially developed at the time of the transfer;
- Intangibles that are not anticipated to be exploited commercially until several years following the transaction;
- Intangibles that separately are not HTVI but which are connected with the development or enhancement of other intangibles which fall within the category of HTVI;
- Intangibles that are anticipated to be exploited in a manner that is novel at the time of the transfer.[595]

The exemption set forth by the deliverable applies where two conditions are met:

- The taxpayer "provides full details of its *ex ante* projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (*e.g.* probability-weighted), and the comprehensiveness of its consideration of reasonably foreseeable events and other risks;" and
- "provides satisfactory evidence that any significant difference between the financial projections and actual outcomes is due to unforeseeable or extraordinary developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction."[596]

4. *Cost Contribution Arrangements (CCAs)*

In a simple and primitive form of cost-sharing, the parent corporation might be exclusively responsible for developing intangible property. The

592. *Id.* ¶ 12.
593. *Id.* ¶ 13.
594. *Id.*
595. *Id.* ¶ 10.
596. *Id.* ¶ 14.

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agreement among it and its subsidiaries would provide for the subsidiaries to bear the "costs" of development, including its "risks," in proportion to their respective "anticipated benefits" of the development. They might bear the costs simply by "funding." The costs would be proportionately charged to the subsidiaries and a payment might be made to the parent for the charge, or the parent might simply forego their shares of the deductions and the deductions would be claimable by the subsidiaries with some sort of receivable set up and paid at some point.

By the time of BEPS, cost-sharing agreements had ceased to be so simple. Provisions had to be made for "buy-in" payments for in-kind contributions by the participants of property or services produced outside the arrangements and for current in-kind contributions made in compliance with the arrangement. Still, however, the prevailing rules permitted centralization of the research activities with account taken of funding and other contributions by the non-central parties.

But, the conceptions that preceded BEPS in the OECD's work, as well as the initial work under BEPS, bore some obvious tensions with this kind of straightforward and readily manageable CCA structure. The AOA and the business restructurings Issues Notes included as Chapter IX of the Guidelines elevated the concept of risk and "control" of risk, and the 2014 recharacterisation deliverable, as indicated above, imported the concept strongly into Chapter 1 of the Guidelines. It made little sense to leave such a concept out of the question in CCAs, but incorporating it into the CCA rules meant that particularized inquiry into questions of "risk" and "control" would make examination of CCAs considerably more complicated and considerably more unpredictable. Similarly, the 2012 OECD Discussion Draft on intangibles and the 2014 Action 8 deliverable reject pretty much altogether the "developer-assister" idea of deferring returns to "assisters" until the embodiment of development in identifiable property, and mandate dividing the return on intangible property in accordance with the contributions to the "development, maintenance, protection, and enhancement" (DEMPE) of the intangible.

The early deliverable on CCAs reflected the conceptual changes foreshadowed by the other deliverables, and by the work of the OECD on AOA and business restructurings. First, the deliverable changed the provisions of the Guidelines concerning permissible participants in CCAs. The 2010 Guidelines had required only that a party have "a reasonable expectation that it will benefit from the CCA activity (and not just from performing part or all of that activity)." It required that the participant "be assigned a beneficial interest in the property or services that are the subject of the CCA, and have a reasonable expectation of being able directly or indirectly (e.g., through a licensing arrangements or sales, whether to associated or independent enterprises) to exploit or use the interest that has been assigned."[597] The 2014 deliverable changed this, requiring that a

597. 2010 OECD Guidelines, *supra* note 424, ¶ 8.10.

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participant "must be assigned an interest in the intangibles, tangible assets or services that are the subject of the CCA, and have a reasonable expectation of being able to benefit from that interest."[598] The deliverable then adds:

> The general principles set out in Chapter 1 of these guidelines on the allocation of risks when delineating transactions apply to situations involving CCAs. Since a CCA is premised on all participants sharing not only contributions but also risks of the CCA activities, to qualify as a participant in a CCA an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA in accordance with the definition of control of risks set out in Chapter I. In particular, this means that CCA participants should have the capability to make decisions to take on the risk-bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor, and direct any outsourced measures affecting risk outcomes under the CCA.[599]

The scope and meaning of these changes are not terribly clear, but on some readings they could greatly restrict the permissibility or operation of CCAs. To take the first set of changes, they seem intended to restrict disproportionate allocations of interests in intangible to central entities organized in tax havens, distributing product to shell distributors in outlet jurisdictions. This is reflected in omissions from the prior text rather than in the explicit text itself: the elimination of the references to benefiting "indirectly," and the elimination of references to sales or licenses "whether to associated enterprises or independent enterprises." But because this inference is from a comparison to the prior text only, it cannot be asserted with real confidence. As to the second passage, it seems to impose a rather high bar for a participant, as it seems to require that all participants have some degree of control over all "specific risks" associated with the CCA "opportunity." This would seem to be inconsistent with the general idea of "sharing" of costs and risks, and might be a standard virtually impossible to meet.

Second, in determining the quantum of a participant's "contributions" to the CCA, the 2014 deliverable (i) greatly shifted emphasis from a conception that such contributions might consist entirely or primarily of cash contributions to one which emphasized in-kind contributions, and emphasized in-kind contributions within the CCA over "platform" contributions of pre-existing services or property, and (ii) made clear that such contributions should ordinarily be evaluated at market value rather than on a pure cost basis. It provides:

> It is sometimes the case that the value (*i.e.*, the arm's length price) of services contributed to a CCA corresponds to the costs associated with providing those services. It may also be the case that the difference

598. 2014 CCA Deliverable, *supra* note 552, ¶ 12.
599. *Id.* ¶ 13.

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> between the value and costs is relatively modest, such as for low value-added services described in Chapter VII. In this case it is recommended for practical reasons to value contributions at cost. However, in all other circumstances (for example where contributions include a mixture of low and high value-adding services and/or intangibles or other assets) costs are unlikely to provide a reliable basis for determining the value of the relative contributions of participants, and the use of costs may led to non-arm's length results.[600]

The widespread use of market value for measuring contributions and determining the amount of any required "balancing payments" plainly introduces greater uncertainty and occasion for dispute than the use of a cost basis. In this manner, the deliverable further undermines the utility and advantage of using CCAs.

Finally, the deliverable requires that a CCA "require balancing payments and/or changes in the allocation of contributions prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants."[601] The 2010 Guidelines suggested only that the CCA "allow" for such changes in such circumstances.[602] The change is in line with the OECD's retreat, manifest principally in the provisions on high-value intangibles, from the stringent opposition it expressed in the 1990s to basing transfer pricing adjustments on information not available to the parties at the outset of their transactions.

B. The Final Document on Actions 8-10

The final document on Actions 8-10 combined the material from all of the two principal deliverables (concerning intangibles and recharacterisation), and four of the five minor deliverables (commodity transactions, hard-to-value intangibles, cost contribution agreements, and low value-adding services), into a single document. This document also included material on profit splits, but that matter was left for a final document to be issued in 2017. There is little mistaking the fact that the final document represented a retreat from some of the advances suggested in the deliverables, a retreat in the direction of restoring concepts that favored taxpayer determination of the outcome of allocations framed/disguised as "rule of law" arguments, and one more tolerant of the "cash box" practice. But that retreat was not complete, and left the BEPS project having made some inroads on the more extreme applications of the system descended from the 1990s.

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600. *Id.* ¶ 23.
601. *Id.* ¶ 42(e).
602. 2010 OECD Guidelines, *supra* note 424, ¶ 8.40(e).

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1. *Recharacterisation and "Control" of "Risk"*

By far the most important change wrought by the Final Reports concerned the provisions of the recharacterisation deliverable, amending Section D of Chapter I of the 2010 Guidelines, concerning risk as a factor in the "functional analysis." The revision establishes an elaborate process for identifying and allocating "risk" among associated enterprises, using particular conceptions of "risk" and "control over risk" largely imported from the business restructuring report. This process restores some respect for contractual allocation as a "starting point" that would have been diminished by the deliverable.

To begin with, the Final Reports are clear that "risk" means not only the threat or possibility of loss, but generally relates to any business uncertainty that has any opportunity for profit. The Report conceded that "[t]here are many definitions of risk," but says that "in a transfer pricing context it is appropriate to consider risk as the effect of uncertainty on the objectives of the business."[603] It stresses that "[i]n all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed," and that "[r]isk is associated with opportunities, and does not have downside connotations alone."[604]

The Final Reports define the term "risk management" as "used to refer to the function of assessing and responding to risk associated with commercial activity." It says "risk management comprises three elements:

> (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function;
> (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and
> (iii) the capability to mitigate risk that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation."[605]

The Final Reports define "control over risk" as "involv[ing] the first two elements of risk management."[606] It says that "[i]t is not necessary for a party to perform the day-to-day mitigation . . . in order to have control of the

603. Organisation for Economic Co-operation and Development [OECD], *Aligning Transfer Pricing Outcomes with Value Creation*, ¶ 1.71 (2015), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en#.WQOgdYWcGUk [hereinafter Final Actions 8-10 Reports].

604. *Id.* ¶ 1.71.

605. *Id.* ¶ 1.61.

606. *Id.* ¶ 1.65.

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risks," because "[s]uch day-to-day mitigation may be outsourced," but also notes that:

> where these day-to-day mitigation activities are outsourced, control of the risk would require capability to determine the objectives of the outsourced activities, to decide to hire the provider of the risk mitigation functions, to assess whether the objectives are being adequately met, and, where necessary, to decide to adapt or terminate the contract with that provider, together with the performance of such assessment and decision-making. In accordance with this definition of control, a party requires both capability and functional performance . . . in order to exercise control over a risk.[607]

The Final Reports define the "financial capacity to assume risk" as "access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequence of the risk if the risk materialises."[608] It says that "[a]ccess to funding by the party assuming the risk takes into account the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialise."[609]

The Final Reports note that "[r]isk can be categorised in various ways," but suggests a "relevant framework" comprising a "non-exclusive list of sources of risk," which is it says is intended neither to "suggest a hierarchy of risk," nor "to provide rigid categories of risk," conceding "there is overlap between categories."[610] The Report lists five categories: "strategic" or "marketplace" risks; "infrastructure" or "operational" risks; financial risks; transactional risks; and hazard risks.[611] It then sets forth a six-step process for analyzing risk in a transfer pricing context. The first step is to "[i]dentify economically significant risks with specificity."[612] The second is to determine how these risks are "contractually assumed" by the associated enterprises "under the terms of the transaction."[613] The third is a functional analysis of how the parties "operation in relation to assumption and management" of these risk, "in particular which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequence of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk."[614] The fourth step is to determine "whether the contractual assumption of risk is consistent with the conduct of associated enterprises

607. *Id.*
608. *Id.* ¶ 1.64.
609. *Id.*
610. *Id.* ¶ 1.72.
611. *Id.*
612. *Id.*
613. *Id.*
614. *Id.*

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and other facts of the case."[615] The fifth step is taken only where the contractual allocation is inconsistent with the parties' conduct or other facts, and involves allocating the risk in derogation of the contractual allocation.[616] The sixth step is the actual pricing, taking into account risks assumptions "as appropriately allocated," and "appropriately compensating risk management functions."[617]

As to the fifth step, the Final Reports are relatively terse, noting that if it is established by the fourth step that the party contractually allocated the risk "does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the associated enterprise or group of associated enterprises exercising the most control."[618] But it concludes, somewhat obscurely, that "[i]n exceptional circumstances, it may be the case that no associated enterprise can be identified that both exercises control over the risk and has the financial capacity to assume the risk," and that "[a]s such a situation is not likely to occur in transactions between third parties, a rigorous analysis of the facts and circumstances of the case will need to be performed, in order to identify the underlying reasons and actions that led to this situation," and that "[b]ased on that assessment, the tax administrations will determine what adjustments to the transactions are needed for the transaction to result in an arm's length outcome," which may entail "[a]n assessment of the commercial rationality of the transaction" under the rules governing non-recognition.[619]

These rules on their face restore considerable scope to contractual allocations, as they are a starting point under step two. In practice and implementation, they are likely to accord even greater scope to those allocations for a number of reasons. Although these guidelines call for identification of "specific" risks that are "economically significant," they concede that different categories of risk overlap. In discussions of business theory or business administration, there is often great analytic advantage in categorizing risk, but in actual practice, the risks so categorized do not exist or operate in isolation. On top of this, the notion of "control" in the Final Reports is rather vague, and even the conception of "financial capacity" is not altogether clear. These considerations mean that in the third and fourth step there are likely to be serious obstacles in most situations to determining a "risk allocation" that is different from the "contractual" allocations, and the contractual allocations are likely to withstand any serious attack in all but exceptional circumstances.

615. *Id.*
616. *Id.*
617. *Id.* ¶ 1.60.
618. *Id.* ¶ 1.98.
619. *Id.* ¶ 1.99.

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2. *Intangibles (Action 8)*

The Final Reports carried forward most of the provisions of the 2014 Action 8 deliverable, but with some significant changes, almost all of which reflected the incorporation of the "risk" and "control" provisions in Chapter I of the Guidelines, or otherwise restored or elevated the significance of legal ownership and contractual allocations. In setting forth a "framework for analysing transactions involving intangibles" at the outset of its section on "contributions to the development, enhancement, maintenance, exploitation and protection of intangibles," the 2014 deliverable identified the following steps, which were elaborations of the approach of the 2012 Discussion Draft on intangibles:

> (i) identifying the legal owner of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, license agreements, other relevant contracts, and other indicia of legal ownership;
> (ii) identifying the parties performing functions (including specifically the important functions described in paragraph), using assets, and assuming risks related to developing, enhancing, maintaining and protecting the intangibles by means of the functional analysis;
> (iii) confirming the consistency between the conduct of the parties and the terms of the relevant legal arrangements regarding intangible ownership through a detailed functional analysis;
> (iv) identifying the controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of intangibles in light of the legal ownership of the intangibles under relevant registrations and contracts and the relevant contributions of functions, assets, risks and other factors contributing to value;
> (v) where possible, determining arm's length prices for these transactions consistent with each party's contributions of functions performed, assets used, and risks assumed; and
> (vi) in the exceptional circumstances described in paragraphs 1.64 - 1.68, recharacterizing transactions as necessary to reflect arm's length conditions.[620]

The Final Reports place as a first step to "[i]dentify the intangibles used or transferred in the transaction with specificity and the specific, economically significant risks associated with the development, enhancement, maintenance, protection, and exploitation of the intangibles," injecting both the idea of "specificity" and "economically significant risks" from the changes added in the final Report to Chapter I.[621] As the second step, the final Report directs:

620. 2014 Action 8 Deliverable, *supra* note 556, ¶ 6.34.
621. *Id.* ¶ 6.34.

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> "[i]dentify[ing] the full contractual arrangements, with special emphasis on determining legal ownership of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, licence agreements, other relevant contracts, and other indicia of legal ownership, and the contractual rights and obligations, including contractual assumption of risks in the relations between the associated enterprises."[622]

Again this elevates the role of contractual assignments, particularly with respect to risks. The Final Reports inject the importance of the central paragraph 6.56 functions into the basic framework; emphasizing the "control" of "risks;" and eliminates specific reference to the authority of the administration to re-characterize the transaction the 2014 deliverable proposed part of the regular procedure, and thus, implicitly diminished the "exceptionality" of such an undertaking.

Later, in stating such authority as the administration has to accurately delineate the actual transaction, the 2014 deliverable provided:

> When no written terms exist, where the contractual terms are ambiguous or incomplete, or where the factual substance of the transaction reflected in the conduct of the parties is inconsistent with the written contracts, the terms of the transaction must be inferred from the conduct of the parties and the economic principles that generally govern relationships between independent enterprises.[623]

The corresponding provision in the Final Reports is distinctly narrower:

> Where no written terms exist, or where the facts of the case, including the conduct of the parties, differ from the written terms of any agreement between them or supplement these written terms, the actual transaction must be deduced from the facts as established, including the conduct of the parties (see Section D.1.1 of Chapter I).[624]

The Final Reports made extensive changes and additions to the provision governing the internal allocations with respect to the DEMPE of intangibles with respect to the provisions on use of assets, particularly in relation to circumstances where the party funding a transaction is not the party in control of the associated operational risks.[625] These generally confine the funding party to a return on the funding risk.[626] The Report changed the provisions governing *ex post* returns to limit adjustments based on such returns by directing attention to whether the parties "properly took into account risks and the probability of reasonably foreseeable events occurring and that the differences between actual and anticipated profitability reflects

622. *Id.*
623. *Id.* ¶ 6.36.
624. Final Actions 8-10 Reports, *supra* note 603, ¶ 6.36.
625. *Id.* ¶ 6.59.
626. *Id.* ¶¶ 6.60-6.64.

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the playing out of those risks," and noting that "it may happen that financial projections, on which calculations of *ex ante* returns and compensation arrangements are based, did not adequately take into account the risks of different outcomes occurring and therefore led to an overestimation or an underestimation of the anticipated profits."[627]

Similar changes reflecting incorporation of the control of risk ideas, and giving greater emphasis to contractual allocations, appear throughout the Final Reports.[628] Perhaps the most significant change the Final Reports make to the earlier deliverable concerns the central functions identified in paragraph 6.56,[629] and the provisions concerning allocations to a "legal owner" with respect to those functions. The 2014 Deliverable provided:

> Because it may be difficult to find comparable transactions involving the outsourcing of such important functions, it may be necessary to utilise transfer pricing methods not directly based on comparables, including profit split methods and valuation techniques, to appropriately reward the performance of those important functions. Where the legal owner outsources most or all of such important functions to other group members, the entitlement of the legal owner to be attributed any material portion of the return derived from the exploitation of the intangibles after compensating other group members for their functions is highly doubtful. In some such circumstances it may also be determined that the outsourcing of such important functions would not have been undertaken by independent enterprises behaving in a commercially rational manner, and that the actual structure adopted impedes the determination of an appropriate transfer price, thereby necessitating the disregarding of the actual structure adopted in accordance with the principles described in [the non-recognition provisions].[630]

This is materially softened in the Final Reports, rendering what had been doubtful merely something that should be carefully considered:

> Because it may be difficult to find comparable transactions involving the outsourcing of such important functions, it may be necessary to utilise transfer pricing methods not directly based on comparables, including transactional profit split methods and ex ante valuation techniques, to appropriately reward the performance of those important functions. Where the legal owner outsources most or all of such important functions to other group members, attribution to the legal owner of any material portion of the return derived from the exploitation of the intangibles after compensating other group members for their functions should be carefully considered taking into account the functions it

627. *Id.* ¶ 6.69. *See also id.* ¶ 6.70.
628. *See id.* ¶¶ 6.40, 6.42, 6.49, 6.77, 6.91, 6.97, 6.104, 6.114, 6.128.
629. *See supra* note 368, Part V-A-1 and text accompanying.
630. 2014 Action 8 Deliverable, *supra* note 556, ¶ 6.57.

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> actually performs, the assets it actually uses and the risks it actually assumes under the guidance in Section D.1.2 of Chapter I. Examples 16 and 17 in the annex to Chapter VI illustrate the principles contained in this paragraph.[631]

The provisions of the 2014 deliverable concerning limitations of the one-sided methods, and on the utility of profit splits, by contrast, were largely carried forward in the Final Reports, except that in the 2014 deliverable there had been references to the "profit split method" without the adjective "transactional." The Final Reports are careful to insert the adjective, and to confine its references to the "transactional profit split method."[632]

3. *Hard-to-Value Intangibles*

The provisions of the June 2015 deliverable, in which the OECD cures itself of its longstanding allergy to retrospective adjustments, largely survive in the Final Reports, perhaps owing to the short time between the issuance of the deliverable and the Final Reports.[633] The Final Reports did make some material changes, largely though not entirely in the direction of narrowing the degree of innovation mandated by the deliverable.[634]

Thus, the Report appears to narrow both the range of circumstances in which resort to *ex post* results may be had and the significance to be attached to such results.[635] Thus, the deliverable distinguishes circumstances where "the difference between the anticipated profit levels and the *ex post* profit levels is not due to unforeseeable developments or events," in which case "the difference gives an indication that the pricing arrangement agreed upon by the associated enterprises at the time of the transaction may not have adequately taken into account the relevant developments or events that might have been expected to affect the value of the intangible and the pricing arrangements adopted," in which case *ex post* profit may be examined, from "the situation in which hindsight is used inappropriately by not taking into consideration whether information could or should reasonably have been known and considered by the associated enterprises at the time of the transfer."[636] It says, therefore, that:

> Special considerations are necessary to ensure that tax administrations can determine in which situations the pricing arrangements as set by the taxpayers are at arm's length and are based on an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of the intangibles involved, and in which situations this is not the case.[637]

631. Final Actions 8-10 Reports, *supra* note 603, ¶ 6.57.
632. *See* 2014 Action 8 Deliverable, *supra* note 556, ¶¶ 6.145, 6.148, 6.149.
633. *See* Yariv Brauner, *Treaties in the Aftermath of Beps*, 41 BROOK. J. INT'L L. 973, 1030 (2016).
634. *See id.* at 1008.
635. *See* 2015 HTVI Discussion Draft, *supra* note 383, ¶ 12.
636. *Id.* ¶ 7.
637. *Id.* ¶ 8.

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The Final Reports, by contrast, describe a more limited approach to the use of *ex post* information:

> [T]his section contains an approach consistent with the arm's length principle that tax administrations can adopt to ensure that tax administrations can determine in which situations the pricing arrangements as set by the taxpayers are at arm's length and are based on an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of certain hard-to-value intangibles, and in which situations this is not the case. Under this approach, *ex post* evidence provides presumptive evidence as to the existence of uncertainties at the time of the transaction, whether the taxpayer appropriately took into account reasonably foreseeable developments or events at the time of the transaction, and the reliability of the information use *ex ante* in determining the transfer price for the transfer of such intangibles or rights in intangibles. Such presumptive evidence may be subject to rebuttal . . .[638]

The Report also modifies (and expands) the list of circumstances that may be exhibited by HTVIs, to the category that the intangible is expected to be exploited "in a manner that is novel at the time of the transfer," and it adds the condition that "the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain."[639] The Final Reports add two other circumstances: (1) that the intangible meeting the definition have "been transferred to an associated enterprise for a lump sum payment;" or (2) where the intangible is either used in connections with or developed under a CCA "or similar arrangements."[640]

The most significant change wrought in the Final Reports is an expansion and strengthening of exemptions to circumstances where *ex post* information is taken into account.[641] The Final Reports add three exemptions:

- Where the "transfer of the HTVI is covered by a bilateral or multilateral advance pricing agreement" (APA);
- Where "[a]ny significant difference between the financial projections and actual outcomes" does not reduce or increase "compensation for the HTVI by more than 20 per cent of the compensation determined at the time of the transaction"; and
- Where a "commercialisation period of five years has passed following the year in which the HTVI first generated unrelated party revenues for the transferee" and the difference in outcomes is not greater than 20 percent for that period.[642]

Also, with respect to the first exemption, the original deliverable stated that where it obtains, "no adjustment to the *ex ante* pricing arrangements

638. Final Actions 8-10 Reports, *supra* note 603, ¶ 6.188.
639. *Id.* ¶ 6.190.
640. *Id.*
641. *See* 2015 HTVI Discussion Draft, *supra* note 553, ¶ 12.
642. Final Actions 8-10 Reports, *supra* note 603, ¶ 6.193.

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based on these special considerations would be justified."[643] The final Report states that in such circumstances, "tax administrations will not be entitled to make adjustments to the *ex ante* pricing arrangements based on *ex post* outcomes."[644]

4. *Cost Contribution Arrangements (CCAs)*

In contrast to the provisions concerning HTVIs, those restricting CCAs were virtually all relaxed by the Final Report.[645] The Final Report did not restore any provisions that contemplated indirect benefits could be taken into account in determining anticipated benefits,[646] but the other innovations suggested by the deliverable were almost all moderated by the final report.

With respect to the determination of what entities could be participants, the Final Report clouded the requirement that participants have control of the risks associated with the DEMPE of an intangible, and made clear that the only risks any participant would be required to control were the specific risks assumed by the participant:

> A party would also not be a participant in a CCA if it does not exercise control over the specific risks it assumes under the CCA and does not have the financial capacity to assume these risks, as this party would not be entitled to a share in the output that is the objective of the CCA based on the functions it actually performs. The general principles set out in Chapter I of these guidelines on the assumption of risks apply to situations involving CCAs. Each participant makes particular contributions to the CCA objectives, and contractually assumes certain risks. Guidance under Section D.1 of Chapter on delineating the actual transaction will apply to the transfer pricing analysis in relation to these risks. This also means that a party assuming risks under a CCA based on analysis under step 4(i) of the framework for analysing risks in paragraph 1.60 ("assumes the risk under the CCA") must control the specific risks it assumes under the CCA and must have the financial capacity to assume these risks.[647]

In connection with the valuation of contributions, the Final Reports retain some preference for valuation based on market value rather than cost, but states the preference in considerably more muted tones.[648] It also distinguishes more sharply than had the original deliverable between current contributions (*i.e.*, those made "within" the CCA), on the one hand, and contributions of pre-existing value, on the other:

643. 2015 HTVI Discussion Draft, *supra* note 553, ¶ 15.
644. Final Actions 8-10 Reports ¶ 6.194.
645. *Aligning Transfer Pricing Outcomes with Value Creation—Revised Chapters I, II, VI, and VII of the Transfer Pricing Guidelines*, Oct. 16, 2015, http://pwc.blogs.com/files/pwc-aligning-transfer-pricing-outcomes-with-value-creation.pdf.
646. *See* Final Actions 8-10 Reports, *supra* note 603, ¶¶ 8.13, 8.14.
647. *Id.* ¶ 8.15.
648. *See id.* ¶ 8.25.

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> In valuing contributions, distinctions should be drawn between contributions of pre-existing value and current contributions. For example, in a CCA for the development of an intangible, the contribution of patented technology by one of the participants reflects a contribution of pre-existing value which is useful towards the development of the intangible that is the objective of the CCA. The value of that technology should be determined under the arm's length principle using the guidance in Chapter I-III and Chapter VI, including, where appropriate, the use of valuation techniques as set out in that Chapter. The current R&D activity under the development CCA performed by one or more associated enterprises would constitute a current contribution. The value of current functional contributions is not based on the potential value of the resulting further application of the technology, but on the value of the functions performed. The potential value of the resulting further application of the technology is taken into account through the value of pre-existing contributions and through the sharing of the development risk in proportion to the expected share of benefits by the CCA participants. The value of the current contributions should be determined under the guidance in Chapters I-III, V, and VII. As noted in paragraph 6.79, compensation based on a reimbursement of cost plus a modest mark-up will not reflect that anticipated value of, or the arm's length price for, the contributions of the research team in all cases.[649]

The Final Reports are lenient on the use of costs in connection particularly with "current" contributions:

> Whereas it cannot be assumed that the value of pre-existing contributions corresponds to costs, it is sometimes the case that cost could be used as a practical means to measure relative value of current contributions. Where the difference between the value and costs is relatively insignificant, for practical reasons, current contributions of a similar nature may be measured at cost in such cases for services CCA. However, in other circumstances (for example where contributions provided by the participants vary in nature and include a mixture of services types and/or intangibles or other assets) measuring current contributions at cost is unlikely to provide a reliable basis for determining the value of the relative contributions of participants, and may lead to non-arm's length results. For development CCAs, the measurement of current contributions at cost . . . will genially not provide a reliable basis for the application of the arm's length principle.[650]

649. *Id.* ¶ 8.26.
650. *Id.* ¶ 8.28.

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act of creating the transferred value. In that sense, the Report ties all methods that apply the arm's length principle to the concept of "options available" as a means to determine the value of transactions.[379] Secondly, if reference is made to the actual act of value creation by group entities in creating the (transferred) assets, it is, akin to the "developer-assister rule" of the U.S. Regulations, equated to cost-bearing in pertinent development/ protection stages of intangible assets by individual entities, regardless of how they re-finance themselves within the group.

The 1995 Guidelines at the outset echo the critique on the arm's length system and thereby implicitly confirm, because they do not attack on a general front, the basic correctness of its findings and that the profit allocation in principle should capture the full economic return to activities performed within a jurisdiction. The 1995 Guidelines introduced the defence line that although the arm's length principle is "viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses," that "[t]here are . . . no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises."[380] And in that vein, the Guidelines do undertake to take value creation—in the sense sketched above—into account when performing the functional analysis[381] or in selecting and applying the transfer pricing methods. Take for instance a problem that is still not fully solved, the tax treatment of economic contributions to the value of intangible assets by distribution entities. The 1995 report, in searching for an appropriate resale price margin, displays its schizophrenia. While it first reasons in purely economic terms correctly that "an appropriate resale price margin is easiest to determine where the reseller does not add substantially to the value of the product," but that

> the resale price margin requires particular care is where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (e.g. trademarks or tradenames) which are owned by an associated enterprise. In such cases, the

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owner of the trademark, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate."

379. *Id.* ¶ 1.16.

380. 1995 OECD Guidelines ¶ 1.9; 2010 OECD Guidelines ¶ 1.10.

381. 1995 OECD Guidelines ¶ 1.21 reads: "The functions that taxpayers and tax administrations might need to identify and compare include, *e.g.*, design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing, and management. The principal functions performed by the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. *While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.*"

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in such a way that the tax base is comprehensively assigned to some tax jurisdiction, and that any part of the base is assigned to one and only one jurisdiction.[656] This principle has been prominently impeached in United States commentary in recent years on either of two grounds: (1) it should not deny the right of taxpayers to plan their affairs to shield some part or even all of their "tax base" from taxation by any jurisdiction,[657] and (2) the principle does not deny to jurisdictions the right to forego taxation of part or all of the tax base to stimulate their economy or for other reasons of economic management, including particularly the promotion of the international competitive position of their economy or their taxpayers.[658] But neither of these concerns really impeaches the notion of a comprehensive assignment of taxing rights: they address, rather, how nations assigned certain rights may exercise the rights assigned, and that is a matter the governance of which the international coordinating system has always explicitly eschewed.[659]

The notion of value creation implicitly reaffirms the conception of a comprehensive but single assignment of taxing rights as envisioned in the Academic Experts' ideal solution to the double taxation problem.[660] Moreover, it does so in a way that emphasizes that the assignment is of jurisdictional authority, without commitment to the manner of exercise of that authority, and which reaffirms that the latter is an internal matter not regulated by international consensus.[661] This point may be obscured first by the fact that presently the content of the notion of value creation is understood, or at least agreed, in only a primitive manner,[662] and second, by that fact that under almost any conceivable understanding of value creation, some room will remain for identifying sources of value which are irreducibly joint results of operations or organisational integration, conceived either with respect to geographic location or organisational identity.[663] But the directive to align the outcome of transfer pricing determinations with value

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656. *See* Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303-04 (1996).

657. H. David Rosenbloom, *The David R. Tillinghast Lecture International Tax Arbitrage and the 'International Tax System,'* 53 TAX L. REV. 137, 153 (2000).

658. Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L. J. 543, 546-49, 554-68 (2001).

659. *See id.* at 548-49.

660. *See* 1923 Academic Experts Report, at 20:

> The ideal solution [to the double taxation problem] is that *the individual's whole faculty should be taxed, but that it should be taxed only once*, and that the liability should be divided among the tax districts according to his relative interests in each. The individual has certain economic interests in the place of his permanent residence or domicile, as well as in the place or places where his property is situated or from which his income is derived." (Emphasis added).

661. Orly Mazur, *Transfer Pricing Challenges in the Cloud*, 57 B.C. L. REV. 643, 663 (2016).

662. Richard Collier et. al., *OECD Discussion Drafts in Six BEPS-Related Areas Raise More Concerns for MNES*, 26 J. INT'L TAX'N 39, 48 (2015).

663. Yariv Brauner, *What the Beps?*, 16 FLA. TAX REV. 55, 75 (2014).

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creation necessarily implies that concepts of value creation should be developed or crystallized in a manner that makes determinate geographic assignment of the totality of business profit (theoretically preferably measured *ex post*), and does so with respect to any defined portion to one and only one jurisdiction.[664]

Beyond that, however, value creation implements the classification and assignment method of assigning primary right to tax business profits to the source jurisdiction by promising, and indeed demanding, a general and widely accepted definition of the source of income, something that, despite an abiding reliance by multijurisdictional systems on the concept of source, has never been accomplished.[665] There has been some tendency in the recent commentary divining an order in the extant collection of international tax rules or norms to associate "classification and assignment" with general theories of taxation, which theories were current and emergent at the time of the League work and have remained influential since.[666] In particular, it has been argued that the assignment of the priority right to tax passive income to the state of domicile reflects the principle of predicating tax responsibility on the taxpayer's ability to pay, while the assignment of a priority right to tax active business income to the source state reflects the principle of basing responsibility on the benefit derived by the taxpayer from government operations.[667]

This construction is objectionable on numerous grounds: it is after the fact, and projects theories back on the period of the 1920s without foundation in the documents surviving the effort involved; it is *simpliste* in the extreme; but most important, it occludes the nature of the task facing the international community in ways that distract it from the most fruitful avenues of inquiry. It is true that the original League documents, the work of the "Academic Experts," extolled the ability-to-pay principle, related it to taxation on the basis of domicile, and incorporated it into its recommendations concerning the allocation principles the experts espoused.[668] But even at the outset, those experts were not prescribing tax policy, either for individual states or for an international order, but rather envisioning a jurisdictional system.[669] The course of the League's work throughout the first decade exhibited this distinction even more clearly as it developed.[670] Thus, in the end, the League carved out different classes of income not on the basis of how the different classes should be taxed, but

664. *See also* Lebowitz, *Transfer Pricing and the End of International Taxation*, 1999 WTD 186-17 (Sept. 27, 1999).
665. Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Tex. L. Rev. 1301, 1307, 1311 (1996).
666. Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 Tax L. Rev. 565, 568–69 (1992).
667. Avi-Yonah, *supra* note 2, at 1305, 1310–11.
668. Graetz & O'Hear, *supra* note 1, at 1035.
669. *See id.* at 1079.
670. Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Tex. L. Rev. 1301, 1304 (1996).

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Henkin[35] and the American Law Institute in its *Restatement (Third) of Foreign Relations Law* based their broad views of the President's power to terminate treaties on the "sole organ" perspective expressed in *Curtiss-Wright*.[36]

Therefore, the Vesting Clause and "sole organ" principle cannot support a plenary power over treaty termination that would allow the President to terminate a treaty in a context where Congress otherwise holds exclusive power.

One of the arguments for independent presidential authority to terminate treaties is the textual analogy with the Appointments Clause, which parallels the Treaty Clause in allowing the President to make appointments "by and with the advice and consent of the Senate."[37] This textual analogy is inapposite because of the substantive difference between terminating a commercial treaty, on the one hand, and removing high-level executive officers, on the other hand. While the latter interferes with no other congressional power, and is firmly within the management of the executive branch, the former could frustrate congressional management of a substantive responsibility accorded exclusively to Congress.

One response might be that commercial agreements may, of course, be made under the Treaty Clause, with only the permission of the Senate, rather than the Congress as a whole.[38] Therefore, this argument goes, the authors of the Constitution accepted that despite the Commerce Clause, Congress, as a whole, would not be involved in the *making* of even commercial treaties. This might support an argument that Congress as a whole need not be involved in the termination of commercial treaties. But the fact that the Treaty Clause constitutes a specific and limited exception from exclusive congressional power over commerce is not a basis for argument that the exclusive character of congressional control of commerce is completely eviscerated, and therefore allows Presidential termination of commercial agreements.

35. However, the authors of the Restatement (Third) accepted that congressional powers might result in modification of the presidential power to terminate. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 339 cmt. a (1987) ("Congress, as distinct from the Senate alone, might perhaps claim a voice in the termination of a treaty where termination might create serious danger of war, in view of the authority of Congress to decide for war or peace under Article I, Section 8, of the Constitution."). Louis Henkin took a similar view. *See* Louis Henkin, *Foreign Affairs and the Constitution*, 66 FOREIGN AFFAIRS 292 (1987).

36. RESTATEMENT (THIRD), *supra* note 35 at § 339 n.1. Section 113 of the Restatement (Fourth) of Foreign Relations Law (2017), is consistent in substance with § 339 of the Restatement Third.

37. For an illuminating discussion, *see* Kristen E. Eichensehr, *Treaty Termination and the Separation of Powers*, 53 VA. J. INT'L L. 247, 269-75 (2013); *see also* RESTATEMENT OF THE LAW FOURTH THE FOREIGN RELATIONS LAW OF THE UNITED STATES TREATIES, TENTATIVE DRAFT NO. 2 § 113 cmt. d (2017).

38. Made in the USA Found. v. United States, 242 F.3d 1300, 1302 (11th Cir. 2001).

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forward in the model conventions and actual double taxation conventions ever since.[678] And the AOA, recognizing it had antecedents in the preliminary OECD studies of the mid-1990s, is the genuine original source of the value creation idea as conceived and embodied, although again trimmed and obscured, in final BEPS-Report on transfer pricing.[679]

The inevitable objection to such a suggestion is the undeniable circumstance that at present the idea of value creation is ill-formed, and thus, it is impossible to demonstrate that the concept can serve as a meaningful definition of the scope of state authority.[680] That objection is unsustainable for two reasons. The first concerns the present state and recent trends in the taxation of corporate profit globally. There is a substantial economic argument for not taxing corporate profits at all, for the abolition of the corporate income tax.[681] That argument is rarely made these days. Corporate profit as a share of national income in the United States is near an all-time high, and the same is true in many if not most nations across the globe.[682] The argument for exempting profits is always difficult to explain to heavily taxed national populations, and is all the more so in this milieu. But the impulse to minimize or eliminate business taxes animates a number of contemporary proposals, many advanced quite seriously. These include measures to substantially reduce the rates of tax on corporate profits, to enact tax holidays of greatly reduced (or zero) taxation for the distribution of untaxed accumulated profits of foreign subsidiaries, and for the exemption of foreign source income under a "territorial" tax system.[683] They also may influence more far-reaching proposals, like the current United States initiative for a "border adjustment" tax, which may have the effect of shifting the actual incidence of what appears as a corporate tax from profits to some other base, like consumption or payroll or a combination of the two.[684] And they clearly animate the defence of *le côté États-Unis* in transfer pricing, with its emphasis on contractual allocations and developer-assister rules, which may represent little more than disguised efforts to provide exemption or very low-rate taxation on the residual profit, especially when coupled with so-called repatriation initiatives.

678. *See* Sheppard, *supra* note 158.

679. *See supra* Part II-B.

680. David Stewart, *'Value Creation' Understanding Key to Transfer Pricing's Future*, 79 TAX NOTES INT'L 322, 322 (2015) (discussing how value is created concerning the issue of transfer pricing policy).

681. *See* Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 86 (1993).

682. Kirk J. Stark, *State Tax Shelters and U.S. Fiscal Federalism*, 26 VA. TAX. REV. 789, 793 (2007).

683. *See* Green, *supra* note 681, at 21, 23, 30.

684. *See* Mark K. Neville, Jr., *The WTO Status of the Proposed U.S. Destination-Based Cash-Flow Tax*, 28 J. INT'L TAX'N 25, 25–26 (2017).

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But for the most part there remains consensus in most nations that some kind of tax on corporate profits is appropriate.[685] But in the modern context, whether animated by underlying hostility to the taxation of profits or otherwise, there is emphasis in almost all theoretical works on concentrating such taxation at the "source" of income.[686] This stance is reflected in proposals for the adoption, universally, of territorial systems, to some extent in the proposals for a Border-Adjustment Tax (BAT);[687] and in what a number of theorists view as a "second best" alternative to a BAT: a formula apportionment system with a single factor sales criterion.[688] The reason that the poor definition of value creation, at the present time, does not vitiate the validity of its use in a traditional transfer pricing system under the classification and assignment method is that in any of these source-centric systems, if pursued with rigor and integrity, the identical problem obtains. A territorial system is little more than a system for restricting corporate taxation (or exempting the residual from taxation altogether) unless there is a better definition than obtains at present of both source and transfer pricing rules—of answering the question of precisely what is the income associated with the identified territory.[689]

A second answer to the difficulty of the primitive state of the value creation idea is that, all things considered, and on closer examination, that state is not altogether entirely primitive. The vision set forth in the Final Reports is limited, but details a concrete, though rudimentary, idea of value

685. Work in the area of international business taxation tends to be of two main kinds. The first involves tax administrators and tax practitioners and seeks on the one hand (the administrators) to formulate rules to allocate business profits among countries based on a market analogy and on the other hand (the practitioners) to argue that the international rules may appropriately lead to profits of multinational corporate groups ending up in low-tax jurisdictions—the hard-boiled wonderland in the title. The other body of work by economists tends to suggest that the income tax for international business income is doomed and that other forms of taxation should be applied to international businesses—the end of the world in the title.

Each of these strikes the author as fantastic in the original sense of the word—much like the novel of Haruki Murakami form which the title of the article is derived. Both seem to ignore the real world. The inside of a multinational firm is not like a market, though it is possible to use some market analogies to sensibly allocate profits among countries. Nor has the corporate tax shown any signs of coming to an end, though subject to strong economic pressures; on the contrary, the tax has remained remarkably buoyant.

Vann Hard-Boiled WonderWorld at 292.

686. Gary C. Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform*, 8-17, 77-94, 131-70 (1992); *see also* Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May be Less Than Enthusiastic about the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. REV. 751, 769 (2006); *see also* Peter Merill et. al., *Restructing Foreign-Source Income Taxation: U.S. Territorial Tax Proposals and the International Experience*, 111 TAX NOTES 799, 799 (2006).

687. Alan Auerbach, Michael P. Devereux, Michael Keen, & John Vella, *A Destination-Based Cash Flow Tax*, OXFORD UNIVERISTY CENTRE FOR BUSINESS TAXATION 17 (2017), https://eml.berkeley.edu/~auerbach/CBTWP1701.pdf.

688. *See* Alan Auerbach & Michael P. Devereux, *Cash Flow Taxes in an International Setting* 33–34 (2017), https://eml.berkeley.edu/~auerbach/Auerbach%20Devereux%202-25-17.pdf.

689. Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 138 (2011).

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If anything, the historical gloss suggests the opposite.[56] The group of commercial treaties examined herein shows that, whether a Treaty Clause treaty or a congressional-executive agreement, the President does not generally claim the authority independently to terminate these agreements. Nor has Congress as a whole, or the Senate for Treaty Clause treaties, acquiesced in independent presidential termination. Furthermore, as a practical matter, the U.S. practice is to enter into trade agreements as congressional-executive agreements, rather than as Treaty Clause treaties. Finally, there is uniform evidence from relevant implementing legislation that Congress, delegating other authority to the President to operate trade agreements, and aware of the question of termination authority, clearly determined not to accord termination authority to the President. This is the opposite of acquiescence: It is denial.

It is important to state at the outset of our review of practice in this field that from the founding of the United States until the late 19th or early 20th century, the President did not generally exercise independent power to terminate treaties.[57] As Curtis Bradley states, "If the Article II Vesting Clause conveyed to presidents the unilateral authority to terminate treaties, it is surprising that no one (with the possible exception of Alexander Hamilton) seemed to be aware of it for a hundred years."[58] So, if historical gloss were valued as simply an indicator of the founders' understanding of the Constitution, it would not support an independent presidential power to terminate treaties. But the Supreme Court has recently stated that "this Court has treated practice as an important interpretive factor even when the nature or longevity of that practice is subject to dispute, and even when that practice began after the founding era."[59]

In his 2014 study of general treaty practice (as opposed to the subset of commercial treaties), Bradley finds that by 1798, it was clear that *Congress* held the power to terminate, and that Congress authorized or directed termination in a number of instances.[60] Furthermore, he observes that "no President actually terminated a treaty unilaterally during the twentieth century until 1927."[61] He finds uncertainty in the period from the beginning of the 20th Century until 1978, but subsequent to 1978, he observes a historical gloss in general treaty practice supporting independent executive power to terminate.[62]

56. Of course, it is also true as a matter of constitutional law that the federal government's power to enter into commercial treaties under the Treaty Clause is independent of the Commerce Clause power. This point is irrelevant to modern trade agreements that do not rely on the Treaty Clause. Moreover, the Treaty Clause provides a special normative power that is explicitly limited to the making of treaties. It does not confer termination power, and none of the arguments of implicit presidential unilateral termination power rely on the Treaty Clause.
57. *See* Bradley, *supra* note 41 at 805, 807.
58. *Id.* at 801.
59. N.L.R.B. v. Noel Canning, 134 S. Ct. 2550, 2560 (2014).
60. Bradley, *supra* note 41, at 789-790.
61. *Id.* at 805.
62. *Id.* at 807, 811.

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enterprises, in economic fact, do not operate as if they were a collection of separate enterprises.[697]

The concepts of the Final Reports correct some of the biases of this production cost approach, only hesitantly and incompletely, but still meaningfully. First, a vice of the production cost approach has been to identify too hastily all the residual profit with intangible property, even in circumstances in which no asset that could intelligently be characterized as property is identifiably present.[698] This vice is noticeable, especially in the United States White Paper.[699] The Final Reports do not suffer from this tendency, at least not to the extent of prior treatments: the Report imposes concrete, though quite expansive requirements that must be met for what constitutes intangible property, and limits the elements of a residual return that can be characterized as a return to intangibles accordingly.[700] Its suggestions concerning the profit split method constitute a limited, but nevertheless meaningful, guide to a course of action in circumstances when the residual cannot reasonably be so characterized.[701] These provisions do leave room for a considerable range of dubious results, but at least there are some limits on what constitutes an intangible asset.[702]

Much more importantly, the terms of the Final Reports introduce some scope, within the Transfer Pricing Guidelines, for employing or at least experimenting with transaction cost concepts without further revision of the Guidelines.[703] These opportunities derive from the central role given the concept of risk in the delineation process, and of the pliable and indefinite notion of risk the new rules articulate.[704] The internalization theory which represents the synthesis of the modern theory both of the firm generally,[705] and the MNE in particular,[706] generally conceives of "transaction costs" as hazards (or risks) avoided by hierarchical organisation. Two kinds of avoided hazards predominate. With respect to production processes (manufacturing (U.S.) or trade intangibles (OECD), in transfer pricing lexicon), internalization avoids appropriation hazards—matters or information cannot

697. Stanley Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 625 (1986); *see also* Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 147–148 (1995).
698. *See* Richard J. Vann, *supra* note 13.
699. *See supra* Part III-C-1.
700. Final Actions 8-10 Reports, *supra* note 603.
701. *See id.* at 4–6, 22.
702. *See id.* at 8.
703. *See id.* at 14.
704. *See id.* at 1.
705. Harold Demsetz, *The Theory of the Firm Revisited*, 4 J. L. ECON. & ORG. 141 (1988); Oliver Williamson, *The Economic Institutions of Capitalism* (1985).
706. Peter J. Buckley & Mark C. Casson, *The Multinational Enterprise Revisited* (2010); Alan M. Rugman, *Internalization and Non-equity Froms of International Involvement*, in NEW THEORIES OF THE MULTINATIONAL ENTERPRISE (A. Rugman ed. 1981); Mark C. Casson, *Transaction Costs and the Theory of the Multinational Enterprise*, in NEW THEORIES OF THE MULTINATIONAL ENTERPRISE (A. Rugman ed. 1981).

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be costlessly disclosed to an unrelated party without the risk they will be appropriated, so joint action requires organisational control.[707] With respect to distribution processes (marketing intangibles, in transfer pricing lexicon), internalization avoids debasement hazards—the risk that a valuable market position will be run down by an unrelated party's use of it without incurring the costs of maintaining and perpetuating it.[708] In both cases, while the economic literature involved tends to speak in terms of costs, it is equally if not more accurate to discuss what is involved as risks (of appropriation or debasement or other problems, as the case may be). And these can be identified as "specific risks" within the terms set forth in the new Section D.[709] So in identifying them, an analysis under that section can be performed to identify the party or parties which "control" the risks within the terms of the section, and an allocation of the profit conceived as associated with transaction cost avoidance, not merely the consequence of a production cost process, can be made.[710] The section's heavy emphasis on the contractual allocation of risk, enforced mainly by the revisions to the Final Reports, is an obstacle to developing ideas along these lines, but it is not necessarily an insuperable one.[711]

In more general terms, the basic idea of the functional analysis of identifying the economic contributions made by the group entities to firm value creation may be an effective instrument to capture the actual value creation of the firm, if and to the extent that the functional analysis can be geared to being also receptive to internal firm specificities such as functions being performed through the specific means provided by the integration,[712] asset specificity created within and by means of joint operations, and risks mitigated through internalizing a transaction (*i.e.*, a transaction costs approach to FAR).

This is not to say that the Final Reports permit an analysis fully consonant with contemporary theory. One conspicuous limitation in this regard entails the report's treatment of location savings. More recent theory of the TNE synthesizes the theory in an "OLI" framework: ownership, localization, and internalization.[713] The theory recognizes that some of the benefit of integrated or hierarchical form obtains from the ability to exploit advantages associated with foreign locale, principally through savings in labor and other

707. Oliver Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975) 8, 18; Mario Guillen & Adrian E. Schoegl, *Building a Global Bank: the Rise of Banco Santander* (2008).
708. *See* Oliver Williamson, *The Economic Institutions of Capitalism* 107-112 (1985); John H. Dunning & Matthew McQueen, *The Eclectic Theory of the Multinational Enterprise and the International Hotel Industry*, in NEW THEORIES OF THE MULTINATIONAL ENTERPRISE (A. Rugman ed. 1981).
709. *See* Final Actions 8-10 Reports, *supra* note 603, ¶ 8.15.
710. *Id.*
711. *Id.*
712. *See, e.g.*, David J. Teece, *A Dynamic Capabilities-based Entrepreneurial Theory of the Multinational Enterprise*, 45 J. OF INT'L BUSINESS STUDIES, 8 (2014).
713. John H. Dunning, *The Eclectic Paradigm as an Envelope for Economic and Business Theories of MNE Activity*, 9 INT'L BUS. REV. 163 (2000).

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costs.[714] A transfer-pricing framework fully consonant with this theory would permit an allocation of profit based on location savings.[715] The BEPS Reports, both the recharacterisation deliverable and the Final Reports, prohibit any direct allocation based on location savings.[716] The matter is a point of disagreement between the developed countries of the OECD and the emerging economies of the Group of 20.[717] The final resolution in the BEPS Report on this issue places it in tension, if not in conflict, with modern firm theory.

In summary, notwithstanding this last point, the Final Report is a start toward a definition of the proper sphere of different jurisdictions of the right to tax corporate profits under any theory of the source of profit from the varying jurisdictions. It is far from fully satisfactory. But especially to the extent it represents agreement among at least the Group of 20, to say nothing of the states that are observers to the BEPS process, it is a measurable and laudable improvement over any prior or pre-existing set of conceptions.[718]

We noted above that the negative grounds for seeking a definition of value creation entailed not only reducing the scope for "cash box" and tax haven abuses, but also avoiding resort to fractional apportionment.[719] Correspondingly, the positive grounds also entail a prong expressing doubt or disfavor of fractional methods, even perhaps in modified form,[720] as the ultimate destination for an international allocation system. The reasons for this are several. First, the OECD's repeatedly reaffirmed principal ground for rejecting fractional apportionment is the difficulty of achieving international consensus on the allocation criteria to be used.[721] This is a serious problem with any move toward fractional apportionment, to be sure, but it is not insuperable, and certainly does not justify the kind of theological opposition to the method frequently voiced, especially in business circles. But the problem, if anything, has become more serious in recent years than it has been historically. This is on account of the sympathy for the method that has emerged among the "emerging" economies, notably by China.[722] In the last half decade, China has become the first country in official pronouncements to express, if not support, at least openness to the use of fractional apportionment as an officially sanctioned allocation method, and

714. *See id.* at 164, 168.
715. Brauner, *supra* note 663, at 1010.
716. *See* Final Actions 8-10 Reports, *supra* note 603, ¶ 1.140–1.151.
717. Dep't of Econ. & Soc. Aff., United Nations Practical Manual on Transfer Pricing for Developing Countries, ¶¶ 10.3, 10.3.8, 10.4, http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf (2013).
718. *See* Gregory Pun, *Base Erosion and Profit Shifting: How Corporations Use Transfer Pricing to Avoid Taxation*, 40 B.C. INT'L & COMP. L. REV. 287, 287 (2017).
719. *See* Brauner, *supra* note 663a, at 1011; *see also* Part II-C-.1.
720. *See* Stanley I. Langbein, *A Modified Fractional Apportionment Proposal for Taxing Pricing*, 54 TAX NOTES 719, 719 (1992).
721. 2010 OECD Guidelines, *supra* note 4, ¶¶ 1.22–1.25.
722. Dep't of Econ. & Soc. Aff., *supra* note 717, ¶¶ 10.3, 8.2.

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China currently seems to seek ways to apply it to the electronic manufacturing services industry (EMS).[723] Thus, the Chinese position appears, if anything, to have hardened opposition by the United States to the method. And, while the United States government has maintained firm support for arm's length, it is among United States state officials and academics that support for fractional apportionment has grown, and has come to include some former officials of the Federal Government after their return to work in the private sector.[724] With respect to this and other issues, antagonism between the United States and China, now the world's two largest economies, appeared to intensify during the course of consideration of the entire BEPS initiative.[725] Potentially polar positions of the world's two largest economies counsels against any kind of optimism towards progress in fractional apportionment.[726] Moreover, China describes fractional apportionment as one option for implementing a contribution analysis, which it contradistinguishes to a risk-based approach, and the BEPS deliverables/reports and the preceding intangibles study, as well as the AOA and Chapter IX of the Guidelines, are all centered on a transition from a risk-based/contractual analysis to some form of contribution analysis, even if the BEPS Final Reports represent a slowing of such movement.[727] Furthermore, as we have attempted to demonstrate throughout, a contribution analysis grounded on the idea of value creation implements the historic classification and assignment method more truly than does the risk-based approach invented in the 1990s. Given that both China and the United States have accepted the Final Reports, the twins rubrics of value creation and contribution analysis would appear to present a better prospect for progress toward genuine international agreement than does the rubric of formula solutions.[728]

More fundamentally, the development of ideas about fractional apportionment in recent scholarship has begun to raise doubt about the value of the idea,[729] notwithstanding its history among the American states,

723. Under this scenario, China takes the view that a *risk-based approach* may have insufficient regard for the fact that there are sizeable assets located in China (*i.e.* the work force and factory plants). In many cases, the majority of the headcount of the EMS group are based in China, with only a few management personnel residing outside of China. Rather than a transactional or profits-based approach, a *contribution analysis approach* may be more suitable. This means that remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group. In this case, the assets and the people should largely dictate where the group's profits should stay, and *a global formulary approach should be a realistic and appropriate option*.
Id. ¶ 10.3.6.3.
724. Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009).
725. Yariv Brauner, *What the Beps?*, 16 FLA. TAX. REV. 55, 63, 94 (2014).
726. *Id.* at 94.
727. David Spencer, *BRICS, BEPS, and the U.N. Transfer Pricing Manual* (PART 2), 24 J. INT'L TAX'N 42, 51 (2013).
728. Brauner, *supra* note 725, at 973, 982, 990.
729. *See* Langbein, *supra* note 694, at 1391, 1410.

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and signal some potential dangers with the approach. A study by a former OECD official and prominent practitioner ably details some of the difficulties that would have to be resolved in designing even a "residual" fractional system:

- It would have to be determined whether to apply apportionment to the entire income of the corporate group, on the one hand, or separately to each "unitary" lines of business, on the other; and if the latter, there would have to agreement on a method for identifying the separate lines of business;
- There would need to be agreement on the determination of consolidated income, and contemporary experience of the efforts of various national/regional accounting standards boards to harmonize international financial accounting standards, or of the European Commission to devise a common consolidated corporate tax base (CCCTB) foretell serious difficulties in doing so;
- There would need to be agreement on the allocation factors (keys in the OECD's language), and each of the potential allocation factors has difficulties of its own.[730]

As to the allocation factors, Andrus and Oosterhuis noted that the CCCTB uses the three factors historically used by the American states (payroll, property, sales), but briefly explore difficulties with each.[731] With regard to payroll and property, there are both measurement problems and problems occasioned by opportunities for taxpayer manipulation. As to measurement, with payroll, there is a question whether to use payroll or headcount—the CCCTB uses a 50-50 average of each.[732] With regard to property, the question is whether to use only tangible fixed personal property, with respect to which there are questions concerning how to treat depreciation, and the further question of the extent to which to include realty, inventory, accounts receivable, and intangible property.[733] With respect to both employment and property, there are problems occasioned by the ability of taxpayers to use independent contractors or to outsource both through contract manufacturing or other devices.[734] These difficulties are most pronounced in relation to high margin, knowledge-intensive enterprises, precisely the same as those that present the most pronounced difficulties under arm's length.[735]

The sales factor raises difficulties concerning remote direct sales by a seller with no presence in the buyer's jurisdiction: sales of intermediate goods and raw materials and the comparable question of sales of capital

730. Joe Andrus & Paul Oosterhuis, *Transfer Pricing After BEPS; Where Are We and Where Should We Be Going*, 95 TAXES THE TAX MAGAZINE 89, 90–91, 96–97, 101 (Mar. 2017), https://www.skadden.com/insights/publications/2017/03/transfer-pricing-after-beps.
731. *Id.* at 96.
732. *Id.* at 98.
733. *Id.* at 98-99.
734. *Id.*
735. *See id.* at 104.

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goods, all presenting the problem whether the sales should be counted at the point of sale, on the one hand, or on a look-through basis on the sale of final goods, sales through third-party intermediaries, and the treatment of franchising and licensing arrangements.[736] All present both measurement problems and opportunities for taxpayer manipulation. Sales of services pose acute problems, conceptually, of determining whether the "place" of sale is the place where the services are performed or the place where they are used, and practically, in determining either the place of performance or the place of use.[737]

Andrus and Oosterhuis note that the problems of measurement and manipulation with respect to the property and employment factors have led a number of states to move to using a single-factor sales method, and that recent proposals for adopting a modified fractional system applicable solely to "residual" profits have proceeded on the suggestion that sales should be used as a single factor.[738] But, they note that suggestions are bound to encounter difficulty with nations in which a taxpayer had substantial production activity, but relatively little sales; they note that the system would certainly "cause a very large shift in corporate tax revenues among various countries compared to today's arm's-length pricing regime."[739]

The design difficulties may not be a sufficient reason to reject fractional apportionment in favor of further refinement of the BEPS/value creation conception. The latter has difficulties aplenty of its own: the Final Reports are a compromise that will surely occasion a welter of interpretive problems, there are questions about the extent of the legal authority of the OECD Guidelines in many if not all nations, and indeed there are indications that taxpayers will challenge the authority of not only the OECD but of Article 9 of the treaties to make the determination of what constitute "commercial or financial relations" between "associated enterprise" a matter of treaty (international), as opposed to national law.[740]

But the abiding difficulty with fractional apportionment, as opposed to value creation, was identified by one of us in 1989: that the internalization theory of TNE yields "no reason to use a single formula applicable to all businesses and all integration settings," but rather "suggests definable

736. Harry Grubert, *Destination-Based Income Taxes: A Mismatch Made in Heaven?*, 69 TAX L. REV. 43, 47, 51, 54–55, 58, 63, 69 (2015).
737. *Id.* at 43–44.
738. Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009); Alan Auerbach, Michael P. Devereux, Michael Keen & John Vella, A DESTINATION-BASED CASH FLOW TAX (2017), *available at* https://eml.berkeley.edu/~auerbach/CBTWP1701.pdf.
739. Joe Andrus & Paul Oosterhuis, *Transfer Pricing After BEPS; Where Are We and Where Should We Be Going*, 95 THE TAX MAGAZINE 89, 101 (Mar. 2017), https://www.skadden.com/insights/publications/2017/03/transfer-pricing-after-beps.
740. Jens Wittendorff, *BEPS Actions 8-10: Birth of a Nation of a New Arm's-Length Principle*, 81 TAX NOTES INT'L 331, 331 (2016); *see also* Jens Wittendorff, *The Object of Art. 9(1) of the OECD Model Convention: Commercial or Financial Relations*, INT'L TRANSFER PRICING J. 200, 200 (2010).

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authorized to proclaim increased duties. . . ."[94] Here, the United States' action to withdraw obligations is separated from the President's action proclaiming duties.

Section 101 of the Trade Act of 1974 also clearly establishes a separation between (i) entry into an agreement, and (ii) proclamation.[95] If this separation between agreements and proclamations is carried forward to section 125, then the President is only authorized to make proclamations to carry out the trade agreement but is not authorized to terminate the trade agreement. Thus, Congress did not by this statute authorize the President to terminate the trade agreements entered under the Trade Act of 1974. Moreover, by an *a contrario* interpretation, it could be argued that this structure stands as evidence of a Congressional intent to deny the President the power to terminate these trade agreements.

Section 125 of the Uruguay Round Agreements Act (URAA) provides that "[t]he approval of the Congress, provided under section 101(a), of the WTO Agreement shall cease to be effective if, and only if, a joint resolution described in sub-section (c) is enacted into law."[96] By this provision, Congress seemed to reserve its right subsequently to disapprove the WTO Agreement, presumably with the result that the U.S. would no longer consider itself bound thereby. While it does not necessarily mean that the President lacks independent termination authority, the "if, and only if" language suggests an intent that this be an exclusive method of U.S. termination. Supporting the latter inference is section 122, which requires the President to consult with Congress prior to participating in making certain important decisions under the WTO Agreement, but does not require consultation on any Presidential act to terminate U.S. participation.[97] This would be a strange omission if the President were intended to have independent power to terminate U.S. participation.

Interestingly, section 107 of the NAFTA Implementation Act of 1993 amended the act that originally implemented the partial predecessor Canada-U.S. Free Trade Agreement (CUSFTA) to provide that when the CUSFTA terminates, its implementing statute would also terminate.[98] This is interesting because Congress recognized the problem that an implementing statute might survive termination of the relevant international agreement and determined to ensure that both would terminate at the same time.

On the one hand, this suggests that Congress saw the problem, and determined not to remedy it in the NAFTA Implementation Act: the NAFTA Implementation Act will not automatically terminate upon termination of NAFTA. On the other hand, it suggests that Congress was

94. *Id.* § 125(c).
95. *See* Trade Act of 1974, Pub. L. 93-618, § 101, 88 Stat. 1978, 1982 (1974).
96. Uruguay Round Agreements Act, Pub. L. 103-465, § 125, 108 Stat. 4809, 4833 (1994).
97. *See* §122, 108 Stat. at 4829–4830.
98. North American Free Trade Agreement (NAFTA) Act, Pub. L. 103-183, § 107, 107 Stat. 2057, 2065 (1993).

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OECD, notably the AOA in connection with transactions involving permanent establishments and the Restructuring Report and Chapter IX of the 2010 Transfer Pricing Guidelines, as the concepts central to the BEPS transfer pricing reports evolved through that work, and that work has previously received little attention, much less understanding, in the United States.

If practitioners need pay heed to the BEPS rules and to developments in relation to BEPS, the observation applies with still greater force to academics and policymakers. It is widely understood that BEPS represents a beginning much more than an end, and that the future promises a great deal of both contention and exploration in refining its approach.[747]

It is also clear that the concept of value creation and identification of the locus of value creation are central to the entire BEPS project, and especially its transfer pricing provisions. This paper has been prepared and is offered in light of these circumstances. There is controversy over whether the concept is novel, and whether it is consistent with prior norms of international tax practice, and over whether such consistency is of any importance, on the one hand, or whether, on the other, the nations of the world should construct their own, contemporary consensus on international tax relations.

In this paper, we have taken a position on both prongs of this question. We believe there is value in continuity with prevailing and long-standing approaches and conceptions, and some danger in departing from them, however alluring the notion of a new, contemporary project might seem in theory. And, at the same time, we believe the value creation ideal, far from representing any serious departure from extant norms, not only is fully consistent with long-standing standards, but may actually represent a perfected manner of expressing those standards—and may promise a perfected guide to illumining practical methods to implement them.

But in this light, it is important to simultaneously have both a careful understanding of the precise content of the international standards and of the manner in which they emerged, and recognition of the contemporary business and technical circumstances that have triggered the substantial international effort to perfect the manner in which the standards are implemented and applied. For this reason, in this document we have emphasized two matters. The first is an analysis of the historical evolution of standards for taxing multijurisdictional business income, particularly as it relates to taxation by a source state, and of the relationship of the value creation ideal to that evolution. The second is an emphasis on the central party/stateless income problem, and the manner in which the transfer pricing rules and practice relate to or indeed generate that problem; and of the influence a recognition of that problem has had on the formulation and

747. Alex Cobham, *Beginning of the End for the Arm's Length Principle?*, TAX JUSTICE NETWORK (Sept. 22, 2017), http://www.taxjustice.net/2017/09/22/beginning-of-the-end-for-the-arms-length-principle/.

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execution of the BEPS project in general and the BEPS transfer pricing rules in particular.

In relation to the first matter, we have sought to show that the original idea developed in the 1920s on the taxation of business income at source was that such income should be taxed by the jurisdiction to which the income bears the greatest degree of economic allegiance. We demonstrate that the earliest Academic Report and a largely neglected Addendum to that Report assimilated the economic allegiance of business income not to autonomous assets and risk, but to human agency, and that this formulation adumbrates the emphasis on "people functions" articulated by the OECD first in the AOA, but then carried forward into the Transfer Pricing Guidelines first through the Restructuring Report and Chapter IX in 2010, and thence into the Final Reports on BEPS Actions 8-10. We show that this spirit carried forward in the 1930s to the work of the League elevating the separate enterprise standard now embodied in Article 9 of the Model Conventions, the basis of the arm's length standard, because there the foundational work of the League justified the arm's length approach, and the reservation of taxing rights to the residual income to the home country, on grounds that the agency of the enterprise's central management performed what might be called people functions to which the residual was attributable.

Still in relation to the first matter, we suggested in the second incarnation of the arm's length principle—that of the 1968 United States regulations and 1979 OECD Guidelines—and the third—the 1994 United States regulations and the 1995 OECD Guidelines—the rules to some extent loosened the tie between the governing principle of economic allegiance and implementing arm's length principle, and the newly designed set of articulate rules elaborated to apply that latter principle. The system of the 1960s established rules rigidly based upon comparables, and more importantly, upon a marginal analysis of the hypothetical behavior of single components of the integrated enterprises. In so doing, the system created ambiguity about, and provided no solutions for allocating, the residual income not allocated by even a complete series of marginal analyses of all the components of the enterprises. In the terms of our approach, the second system displaced the idea of the original arm's-length regime, which had allocated the residual to the parent company on the theory that the economic allegiance of the residual was to the home country, because that is where the central managers were and because the central managers were the producers of the residual—with one which disavowed responsibility for any theoretical explanation of the residual. The second system failed when inevitably this approach gave no convincing answers to practical situations, leaving taxpayers, administrators, and courts to make apparently arbitrary decisions.

The third system addressed the surface symptoms of the second—schizophrenic prognoses and indeterminacy—without addressing its underlying cause, which was the lack of connection to the more general rubric of economic allegiance. The result was that the reform bore vices

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probably greater than any the reform cured. For in operation, if not in intent, the linchpin of the third system is emphasis on the contractual allocations devised, supposedly by agreement among the various components of the integrated enterprise, but of course in actuality determined by the central management of the unified entity. This, coupled with the retention (and indeed the expansion) of the methods by which the marginal analyses of the second system were accomplished, had an inevitable result. In loyalty to their kind, to use the Jefferson Starship's phrase, corporate management in short order figured out that they could form a largely nonfunctional entity in a low-tax jurisdiction, move the functions, assets, and risks emphasized by the rigid third system predominantly to that entity, and contractually allocate the entire residual to that entity. This disabled the capacity of the jurisdictions where manifestly the most important economic activity involved in producing the income takes place—where products and services are made, grown, manufactured, where the means of producing them are conceived and designed, and where lie the markets in which goods and services are sold or distributed—to tax the profits so generated. The profits, in other words, were shifted, and the base of economically involved states eroded, to the detriment of the fisc in any such state. This base erosion and profit shifting also operated to the detriment of any purely domestic enterprises in the economically involved states, because those enterprises have to endure taxation of any residual profit their operations generated, while their multijurisdictional competitors did not.

In other words, the third system displaced a predecessor whose vice was indeterminacy and uncertainty, with one whose vices were the multiples ones of inequity, inefficiency, and fiscal stress. And the third system, again more than the second, strayed from any effort to tie its rules to the concept of economic allegiance. Indeed, the system all but flouted the larger idea, because there was no identifiable reason to believe that intercorporate contracts unilaterally devised by TNE central managements would allocate income in a way that had anything to do with the larger ideal. Instead, the new system rapidly degenerated it one whose governing idea could only be said to be a principle that the residual income should be virtually exempt from tax. That notion is and would be sufficiently unacceptable and unpopular that, while partisans stridently defended arm's length as a fundamental principle in itself and laud the stress on contractual allocations without regard to the fact that such a device had never been used in the first two incarnations of arm's length, no one ever articulates or openly advocates the only real principle than can meaningfully be said to underlie the third system.

Which brings us to the second matter we have emphasized—the role of the central party/stateless income problem to both the processes of substantive policies of BEPS. We have just noted that and how that problem emerged largely on account of the revisions of the transfer pricing standards adopted in the mid-1990s. But we have deemed it important to note the

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extent to which there was ambivalence on the part of the OECD even from an early date about the manner in which the revised rules would function and were functioning. Thus, we have detailed the OECD's various demurral and qualifications concerning the United States regulations as they emerged, and the extent to and manner in which the final 1995 OECD Guidelines preserved many of these sentiments and perceptions.[748] Beyond that, we have emphasized that the OECD in both the AOA[749] and the Restructuring Report[750] frankly repudiated features of the 1995 Guidelines which undergird central parties and stateless income—in the AOA, by refusing to permit any analogue of contractual allocations to serve as a starting point for allocations of income among branches of a singly incorporated enterprise operating in different jurisdictions, and in the Restructuring Report, by mandating a transfer pricing adjustment when functions, assets, and risks are transferred from components of an enterprise which the transfers render limited function, to an enterprise which becomes or is becoming a central party. We deem an understanding of the retreats from contractual allocations embodied in these two studies critical to understanding BEPS.

In addition, comprehension of the controversy surrounding contractual allocations is essential to understanding the evolution of the BEPS Reports themselves. We have examined that evolution in detail. We compare in detail in Part V the various deliverables and discussions drafts with corresponding provisions of the Final Reports. But really in the evolution of BEPS there were four stages, the first two of which were brief and are surveyed by Part I. The first stage was in the original Addressing BEPS Report of the OECD, issued in February 2013,[751] and the second was the Action Plan issued in mid-2013.[752] The deliverables/discussion drafts were the third, and the Final Reports the fourth. We have shown that through these four stages there is a steady movement away from approaches that would have constituted sharp departures from the status quo, and toward approaches effecting more limited change. This recapitulates movement that has occurred in relation to prior episodes in the development of international tax standards. In the original formulation of the system in the 1920s, the process was instituted with the 1923 Report of the Academic Experts,[753] which articulated what might be characterized as more theoretically pure principles. These were compromised by practical and political concerns, and by the differing interests of the different nations, as the process moved through the 1925 and 1927 Reports of the Technical Experts,[754] and the final recommended Models published in 1928.[755] So, too,

748. *See supra* Part III-C-2.

749. OECD PE Report; *see supra* note 413; *see supra* the discussion in Part IV-A.

750. 2008 OECD Discussion Draft; *see supra* note 450; *see supra* the discussion in Part IV-B.

751. *Addressing BEPS*. *See supra* note 82 and accompanying text.

752. *OECD 2013 Action Plan*. *See supra* note 80 and accompanying text.

753. 1923 Academic Experts Report. *See supra* note 141 and accompanying text.

754. 1927 Technical Experts Report; 1925 Report of First Technical Experts Committee. *See supra* note 134 and accompanying text.

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A Case of Motivated Cultural Cognition: China's Normative Arbitration of International Business Disputes

PAT K. CHEW*

I. Introduction

A formalist model imagines that judges and arbitrators resolve disputes in a wholly deliberative and rationale way.[1] The assumption is that they identify the appropriate legal principles, objectively apply them, and ultimately reach predictable results. This model of decision-making as highly predictable and objective, however, is illusory.[2] Judges and arbitrators instead are more human and less mechanical—they pour more of themselves into their cognitive processing. As Kahan indicates, they unwittingly shape outcomes consistent with their own innate preferences.[3]

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* Sullivan & Cromwell Visiting Professor of Law, Harvard Law School, spring 2018; Judge J. Quint Salmon & Ann Salmon Chaired Professor of Law, University of Pittsburgh School of Law. I appreciate the support of Deans William Carter, Amy Wildermuth, John Manning, and Martha Minnow. Daniel Chow, Christopher Drahozal, Kevin Kim, Robert Kelley, Lauren Kelley-Chew, Jacqueline Nolan-Haley, Jennifer Robbennolt, Catherine Rogers, Nancy Welsh, Margaret Woo, Mark Wu, and Don Zheng offered valuable suggestions on my research. My research team included Jingjing Xia, Serene Lueng, James Li, and Biwei Xa. Jingjing Xia was instrumental in acquiring the original CIETAC materials and in meticulously supervising the data compilation process. Scott Beach and Janet Schlarb from the University Center for Social and Urban Research and Caiyan Zhang of the College Board consulted in the research design and statistical analyses. I am also grateful for the opportunities to share this research at the American Bar Association Annual Conference on Dispute Resolution, the Conference of Asian and Pacific Island Law Faculty, Harvard Law School, and Southern Methodist University Law School. Any errors or omissions are mine alone.

1. BRIAN Z. TAMANAHA, BEYOND THE FORMALIST-REALIST DIVIDE: THE ROLE OF POLITICS IN JUDGING 1 (2010); Brian Leiter, *Legal Formalism and Legal Realism: What is the Issue?* 16 LEGAL THEORY 111 (2010).

2. *See e.g.*, Chris Guthrie et al., *Blinking on the Bench: How Judges Decide Cases*, 93 CORNELL L. REV. 1, 19–29 (2007); Tracey E. George & Taylor Grace Weaver, *The Role of Personal Attributes and Social Backgrounds on Judging*, *in* THE OXFORD HANDBOOK OF U.S. JUDICIAL BEHAVIOR 286–298 (2017); Kahan et al., *infra* note 3, at 356–368; Holger Spamann & Lars Klein, *Justice is Less Blind and Less Legalistic Than We Thought: Evidence from an Experiment with Real Judges*, 45 J. LEGAL STUD. 255, 255–259, 268–277 (2016); Dan M. Kahan, *Culture, Cognition, and Consent: Who Perceives What, and Why, in Acquaintance-Rape Cases*, 158 U. PA. L. REV. 729, 731–761, 793–807 (2010) (research exploring humanness of judicial decision-making).

3. Dan M. Kahan et al., *"Ideology" or "Situation Sense"?: An Experimental Investigation of Motivated Reasoning and Professional Judgment*, 164 U. PA. L. REV. 349, 356 (2016).

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Appendix

OECD Action Items Pertaining Directly to Transfer Pricing (Actions Items 8-10, 13)

Action 8 titled "Intangibles," directs the initiative to:

> 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.

Action 9, entitled "Risks and capital," provides that the initiative will:

> 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 coordinated with the work on interest expense deductions and other financial payments.

Action 10, entitled "Other high-risk transactions," provides that the initiative will:

> Develop rules to prevent BEPS by engaging in transactions that 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.

Action 13, entitled "Re-examine transfer pricing documentation," provides the initiative will:

> Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed

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information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

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