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United States Policy and the Taxation of International Intangible Income

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The Tax Cut and Jobs Act of 2017 ("TCJA")[1] enacted sweeping changes in the international tax provisions of the United States Internal Revenue Code. In particular, with respect to the corporate tax, the enactment abandoned a historic "residence-based" or "global" system and replaced it with a modified "territorial" system based upon what the statute terms a "participation exemption" structure.[2]

Territorial systems visibly place great importance on determining how income is associated with a taxing jurisdiction. Historically, this determination has been effected by two different but related sets of rules: "source" rules, which have been mostly the subject of domestic laws of various countries, which assign to items of income and deduction a geographic "source";[3] and "transfer pricing" rules, which are the subject of some degree of international agreement, and which allocate the tax base of integrated corporate entities among the different jurisdictions from which such entities derive income.[4]

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1 Tax Cuts and Jobs Act, Pub. L. No. 115–97, 131 Stat. 2155 § 13543 (2017).

2 A global or residence-based system imposes tax on the global income of individuals deemed subject to the jurisdiction of the taxing authority. It is not a system which gives "primacy" to the authority of the jurisdiction based on personal characteristics over that of the jurisdiction based on the relationship to the "origin" of the tax base, because it may cede primary authority to the latter, reserving only residual authority to the former. In the United States, authority to tax incorporated entities has historically been based upon the jurisdiction under the laws of which the entity is organized. *See* I.R.C. §§ 7701(a)(3)–(4) (2017) (providing the definition of "domestic" corporation).
A "territorial" system, by contrast, imposes tax solely on the basis of the relationship of the jurisdiction involved to the tax base: jurisdictions impose tax on income earned within their "territory," irrespective of the relationship of the jurisdiction to the party to which the tax base is attributable. Thus, the "foreign" origin tax base of domestic parties is exempt; but the "domestic" origin tax base of foreign entities is subject to tax.
The change effected by the TCJA was limited to corporations. Individuals and unincorporated entities remain subject to the pre-existing "global" system, subject to some major changes, the most significant of which are discussed in the text.

3 The rules defining the geographic "source" of taxable income under United States law are set forth in Part I of Subchapter N of the Internal Revenue Code, I.R.C. §§ 861–65 (hereinafter "the Code"), and regulations thereunder.

4 The transfer pricing rules under United States law are for the most part set forth in regulations under section 482 of the Code, a brief section which gives the Treasury Department authority to allocate items of income, deduction, gain or loss

The latter set of rules, by far the more important, have been the subject of near constant international controversy for over a half century.[5] In recent years, this controversy has increasingly centered on what is loosely, and with a grave degree of license, called "intangible" income[6]—by which is meant, for the most part, income from what we would call intellectual property, patents, trademarks, copyrights, knowhow, and trade secrets. The problem of deciding the jurisdictions to which such income is assignable has proved to be intractable, even at the time the share such income constitutes of

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or credit among entities or trades and business under "common control." The regulations under these provisions are extensive and have a substantial and significant history, covered in parts II-IV *infra*.

Actually, there is a complication to this two-part schema, applicable under United States law, but also pertinent to the laws of some foreign countries and the international rules. The transfer pricing rules, strictly speaking, apply where an enterprise of one state conducts business outside that state through separately incorporated entities. Enterprises also conduct business outside their home countries without forming separate corporations or other entities in the foreign state—through foreign branches. This is most common in the banking and financial services sector. In the United States, where a foreign enterprise conducts business other than through a separate corporation, the United States tax base is determined in the first instance by the source rules, supplemented by rules which limit and expand the base defined by those rules according to whether income is "effectively connected" with the United States business, a concept which excludes some United States source income and includes some income which is foreign source. I.R.C. § 864 (2017). Income from foreign unincorporated branches is included in the tax base of United States entities, subject to a foreign tax credit the magnitude of which is limited by the source rules. This is true even after the TCJA, because that law did not extend the "territoriality" principle to enterprises operating abroad through unincorporated branches.

There is an alternative way of determining foreign branch income which does not depend on the first category of rules (source rules), but rather on the latter (transfer pricing rules). This method appears to be mandated by the model conventions of international organizations, as well as most bilateral income taxation conventions in force throughout the world. But this approach was never adopted by United States regulations and never developed by the international organizations until 2002-2010. The manner in which those organizations did so is significant to the discussion within and is described at length in Part IV *infra*.

[5] These controversies and their resolution are detailed in Parts II-IV *infra*.

[6] The nature of that license and the ambiguities involved are described in Part I *infra*.

total income earned worldwide has increased (and appears still to be increasing) exponentially.[7]

The latest acute phase of these difficulties arose, and was partially or temporarily resolved, in the first of the decade of the 2010s by what is known as the "base erosion and profit shifting" initiative of the Group of 20, effected through the Organization for Economic Co-operation and Development ("OECD").[8] The initiative was sparked by a series of press reports,[9] backed by some academic work,[10] which exposed practices of certain multinational corporations, principally "based" in the United States, and most but by no means all concentrated in the United States technology industry, by means of which the enterprises reduced their overall tax rate (taxes

[7] This confusion is manifest perhaps most visibly, and seriously, in a comprehensive study of transfer pricing undertaken by the Treasury Department in the late 1980s at the express direction of Congress. UNITED STATES TREASURY DEP'T, A STUDY OF INTERCOMPANY PRICING 182–83 (1988) (issued as I.R.S. Notice 88–123, 1988–2 C.B. 458). The disjunction is the root of what I and a co-author call the "hybrid/schizophrenic" nature of the conclusions of that report. Stanley I. Langbein & Max R. Fuss, *The OECD/G20 BEPS Project and the Value Creation Paradigm*: *Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard*, 51 INT'L LAW. 259, 320–21 (2018); *see also* Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation,* 113 COLUM. L. REV. 1347 (2013); Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79 (2008).

[8] On the BEPS project generally, *see* Langbein & Fuss, *supra* note 7.

[9] The most influential early articles were by the same author for *Bloomberg News.* 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; *see also* Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES (Apr. 29, 2012), https://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html; Zaid Jilani, *Microsoft Structured Acquisition Of Skype To Avoid U.S. Taxes*, THINKPROGRESS (May 13, 2011, 3:00 PM), http://thinkprogress.org/2011/05/13/microsoft-skype-tax-havens.

[10] Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011); Edward D. Kleinbard, *Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011); *see also* Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2012).

paid to all countries) to near zero.[11] In 2013, the OECD established an "action plan,"[12] divided into fifteen areas for action, and the groups assigned to work on each action area produced two rounds of documents recommending action. The first, published for the most part between the late summer of 2014 and the late winter of 2015, were preliminary deliverables and discussion drafts, circulated for comment among the G-20 nations. The second were final recommendations published for the most part in the autumn of 2015. Among the fifteen action "items," undoubtedly those of central importance concerned transfer pricing, Actions 8 through 10.[13] For the most part, the content of these 2015 reports constituted amendments to and by 2017 were incorporated in the 2017 version of, the OECD's TRANSFER PRICING GUIDELINES FOR MULTINATIONAL

[11] *See* Joseph B. Darby III & Kelsey Lemaster, *Double Irish More than Doubles the Tax Saving: Hybrid Structure Reduces Irish, US and Worldwide Taxation*, 11 PRACTICAL U.S./INT'L TAX STRATEGIES 2 (2007); Jeffrey L. Rubinger & William B. Sherman, *Holding Intangibles Offshore May Produce Tangible Tax Benefits*, 106 TAX NOTES 938 (2005).

The matter also triggered a series of congressional hearings in the United States. *Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple, Inc.*), S. Hear. 113-90, *Hearings before the Permanent Subcommittee on Investigations, Committee of Homeland Security and Government Operations*, May 21, 2013 available at www.fds.gov.; *Offshore Profit Shifting and the U.S. Tax Code – Part 1 (Microsoft and Hewlett-Packard*.), S. Hear. 112-781, *Hearings before the Permanent Subcommittee on Investigations, Committee of Homeland Security and Government Operations*, Sept. 20, 2012, available at http://www.gpo.gov/fdsys/pkg/CHRG-112shrg76071/pdf/CHRG-112shrg76071.pdf; *Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple, Inc*.), S. Hear. 113-90, *Hearings before the Permanent Subcommittee on Investigations, Committee of Homeland Security and Government Operations*, May 21, 2013, available at http://www.gpo.gov/fdsys/pkg/CHRG-112shrg81657/pdf/CHRG-112shrg81657.pdf; *Caterpillar's Offshore Tax Strategy*, S. Hear. 113-408, *Hearings before the Permanent Subcommittee on Investigations, Committee of Homeland Security and Government Operations*, Apr. 1, 2014, available at http://www.gpo.gov/fdsys/pkg/CHRG-112shrg89253pdf/CHRG-112shrg89253.pdf.

[12] ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, ACTION PLAN ON BASE EROSION AND PROFIT-SHIFTING, (July 19, 2013), http://www.oecd.org/tax/action-plan-on-base-erosion-and-profit-shifting-9789264202719-en.htm.

[13] *See* Appendix (full text of Actions 8 through 10).

ENTERPRISES AND TAX ADMINISTRATIONS, "the OECD Transfer Pricing Guidelines," or, more simply, "the Guidelines."[14]

The United States participation in the development of the BEPS standards was curious. The most recent two previous episodes of transfer pricing controversy were instigated, all but unilaterally, by the United States. In the first, the United States had issued far reaching and complex regulations in the late 1960s,[15] and this led to the formulation of the first version of the Guidelines, in 1979, which largely followed the terms of the United States regulations.[16] In the second, the United States Congress had expressed dissatisfaction with the function of the regulations formulated in the 1960s,[17] and this had led to an extended, decade long process of international negotiations concerning international transfer pricing standards, culminating with a revision of the Guidelines in 1995.[18] Again, however, the United States issued regulations *prior to* the finalization of the revision of the Guidelines,[19] and again, the revisions of the Guidelines followed the United States regulations, although this time the differences were considerably more material, and some touched even on conceptual matters.[20]

But those differences foreshadowed a real dissolution of the cohesion of United States and international principles after 1995.[21] In

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[14] ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2017) [hereinafter *2017 Transfer Pricing Guidelines*].

[15] TD 6998, 34 Fed. Reg 933 (Jan. 17, 1969); TD 6952, 33 Fed. Reg. 5848; *see* Langbein & Fuss, *supra* note 7, at 310–16.

[16] ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (1979).

[17] H.R. Conf. Rep. No. 99-841, at II-638 (1986) (Conference Report on the Tax Reform Act of 1986).

[18] For an account of what these authors call the "great transfer pricing wars" of the 1985-95 period, *see* Michael C. Durst & Robert Culbertson, *Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today*, 57 TAX L. REV. 37 (2003)*; see also* Langbein & Fuss, *supra* note 7, at 318–29.

[19] TD 8552, 59 Fed. Reg. 34, 971 (July 8, 1994); *see also* TD 8632, 60 Fed. Reg. 65, 553 (Dec. 19, 1995); Langbein & Fuss, *supra* note 7, at 323–26 & n. 309.

[20] Langbein & Fuss, *supra* note 7, at 329–36.

[21] *See generally* Langbein & Fuss, *supra* note 7, at 341–63.

the decade preceding BEPS, between 2000 and 2010, the OECD exhibited distinct consciousness of the difficulties which became a major focus of public concern after 2010. These concerns were manifested first in revisions of standards governing the allocation of income where a multinational enterprise operated in different countries through unincorporated branches or entities, rather than separately incorporated entities[22] and second in rules specifying transfer pricing consequences for transactions by which such entities rearranged their operations through their commonly controlled, separately incorporated entities.[23] The United States participated in the proceedings concerning these issues and thus in the development of the revised standards. But the revised standards had no parallel whatever in pre-existing United States policy or law, and both the Congress, with regard to legislation, and the Treasury, with regard

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[22] The final results of this project were issued as ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT , ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (2008) [hereinafter *2008 OECD PE Report*]. The 2008 report stated that Article 7 of the OECD Model Convention on the Taxation of Income and Capital and the Commentary to that Convention would be revised in the next update of the OECD's Model Convention, then scheduled, and ultimately released, in 2010. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, MODEL DOUBLE TAXATION CONVENTION ON TAXES ON INCOME AND CAPITAL, art. 7 (2010). The final report also revised the Commentary to Article 7, effective with the 2010 update on the Model Convention, with respect to matters that did not conflict with the pre-existing commentary. The report cautioned "taking care, when interpreting bilateral treaties that include the current text of Article 7 . . . to use only the parts of the Report that do not conflict with the Article 7 Commentary as so revised." *Id.* at 8, ¶ 8. The various discussion drafts and other preliminary reports leading to the final Guidelines are discussed in *The OECD/G20 BEPS Project and the Value Creation Paradigm*: *Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard*. Langbein & Fuss*, supra* note 7, at 341–50.

[23] The OECD's final report on this initiative was issued as ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, 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. As that title indicates, the results of this project were incorporated into the Guidelines as a new Chapter IX, where they still appear. The various discussion drafts and other preliminary reports leading to the final Guidelines are discussed in *The OECD/G20 BEPS Project and the Value Creation Paradigm*: *Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard*. Langbein & Fuss, *supra* note 7, at 350–63.

to regulations, ignored the new standards and made no effort whatsoever to reflect them in United States statutory or regulatory law.

The BEPS initiative and the revision of the 2017 Guidelines represented in substantial part an extension of the principles elaborated in these two earlier OECD efforts.[24] And, in keeping with the United States' previous somnolence in regard to those rules, the United States at first paid little attention to the new initiative, which, at least as far as public manifestations were concerned, were spearheaded by the major European powers (France, Germany, and the United Kingdom).[25] This dalliance ended abruptly, however, with the publication of the 2014 deliverables with regard to transfer pricing. The United States played a very active role in the late stages of the BEPS process by seeking, and achieving, significant revisions in the final BEPS report (which became the revised Guidelines) all of which pointed in the direction of diluting the degree to which the final report strengthened the hands of tax administrators in enforcing transfer pricing rules.[26] And, largely as a result of the efforts of the United States, the BEPS process over its life, from 2012 to 2017, moved steadily from its initial promise of significant reform to a final product effecting genuinely minor reform.[27]

The adoption of a territorial system, with no transfer pricing reform, can readily be seen as a retreat, while the BEPS reform, even cast in the most skeptical light, constitutes an advance. But the TCJA did not stop with the enactment of "territoriality." The TCJA included three measures that at least on the surface addressed the "base erosion" and "profit shifting" concerns of the international

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[24] *See generally* Langbein & Fuss, *supra* note 7, at 341–89; Part III-IV *infra*.

[25] *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 (Nov. 6, 2012), https://www.theguardian.com/business/2012/nov/05/uk-germany-tax-loopholes-multinationals; Langbein & Fuss, *supra* note 7, at 274 n. 80.

[26] Brookings Institution, *OECD BEPS Action Plan: Taking the Pulse on the Americas Region*, 18 BROOKINGS INSTITUTE (February 2016) ("Many of the OECD's recommendations have been revised to address US concerns about the original proposals.") https://www.brookings.edu/wp-content/uploads/2016/04/bepsupdateamericas-manal-corwin-addition.pdf.

[27] *Id.*

community. The first two concerned the taxation of the foreign activities of United States persons[28]—the so-called "outbound" situation. The TCJA enacted a new, residual tax on what it calls the "global intangible low-taxed income" ("GILTI") of subsidiaries of the United States corporations.[29] At the same time, the TCJA enacted a second measure, applicable to activities of United States persons whose foreign activities are conducted through "branches," that is, without separate corporate entities to conduct the foreign activities, designed to equalize the taxation of such activities with the activities subject to the GILTI tax. Section 250(c) enacts a special deduction for this "foreign direct investment income" ("FDII"). The third relevant provision applies to the United States activities of foreign persons, on whom new section 59A imposes a minimum tax, called the "base erosion anti-abuse tax" ("BEAT").[30]

But, with the enactment of the GILTI tax and the accompanying base erosion and anti-abuse tax ("BEAT"), the United States' response to BEPS is quite different from its response to the OECD's earlier Article 7 and restructuring initiatives. In the earlier episodes, as noted, the United States stood still and quiet and made no changes

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[28] The GILTI tax is described in detail in Part V *infra*. United States persons include citizens and residents of the United States; domestic corporations and domestic partnerships; and certain trusts and estates. I.R.C. § 7701(a)(30) (2017). The United States for these purposes includes only the fifty states and the District of Columbia. I.R.C. § 7701(a)(9). Corporations or partnerships are "domestic" if created or organized in the United States or under the laws of any state or of the United States. I.R.C. § 7701(a)(4) (2017).

[29] The GILTI tax applies to income imputed from "controlled foreign corporations" ("CFCs") to United States persons who are "United States shareholders" with respect to those CFCs. These terms derive from provisions in force before the TCJA (and since 1962) under Subpart F of Part III of Subchapter N of the Code. A CFC is a foreign corporation with more than 50 percent of the stock of which (by vote or value) is owned by "United States shareholders," I.R.C. § 957(a), and a "United States shareholder" is defined as any United States person who owns ten percent or more of the value or voting power of the stock of the corporation. For these purposes, ownership is determined using certain "constructive ownership" rules, I.R.C. § 958(a)-(b), which impute ownership to a person stock owned by certain closely related individuals or entities. These constructive ownership rules were amended by TCJA in ways which greatly expand the number of foreign corporations which will be treated as CFCs, and the identity of United States persons who will be treated as United States shareholders.

[30] As with the GILTI provisions, the FDII and BEAT provisions are detailed in Part V *infra*.

in its law at all. But now the United States has effected major statutory change. The GILTI tax does not by its terms affect the transfer pricing rules, but it greatly affects the *consequences* of many if not most transfer pricing determinations and squarely concerns the major issue which motivated the BEPS transfer pricing efforts if not the entire BEPS process itself, viz., the taxation of income from intangible property, or, more generally "intangible income." So too the FDII and BEAT provisions.

At the same time, the enactment of these provisions poses some interesting, if odd, questions. Underlying these are the circumstances that the statutory changes, while involving the same policy concerns as the BEPS report, in no way adopt or even reflect the rules, recommendations, or principles of those reports, except perhaps for the cursory use of the term (or shibboleth) "base erosion." So, in this circumstance, while the United States response differs from the earlier interludes in that *there is* a response, the United States response in common with the earlier moments *virtually ignores the substantive standards* elaborated by the international body. This is stranger still in light of the historical pattern of congruence of the two sets of standards and even more in light of the pattern of American leadership—one could even say domination—of the development of standards.

And these circumstances lead to the question of just what is contemporary United States policy toward the taxation of income from intangible property. The United States, after all, subscribed to, and played a significant role in, the OECD BEPS standards, so why influence, or even vote for, standards the nation intended, probably all along, to ignore? The aim of this piece is to explore this question of the content, going forward, of the substantive congressional and administrative policy in regard to taxing cross border income derived from intellectual or other intangible property, as well as the shares of the profits of multinational enterprises that cannot be definitively linked to identified factors of production.

I. "INTANGIBLE INCOME"

A. The question of "intangibles."

If we are to discuss "global low-taxed intangible income," we might logically if somewhat facilely start by identifying what may be meant by "intangible income." The term has a critical ambiguity, greatly inflamed by contemporary United States commentary, which is best drawn out at the outset. Narrowly, the term may mean income from "intangible property"; by the latter term, we may mean intellectual property (patents, copyrights, secret processes, trade secrets generally), but also from rights associated with the operation of an ongoing concern (trademarks, trade names, going concern value, goodwill).[31] More broadly, and alternatively, it may mean any such income, *plus* any income that cannot be definitively associated with some other factor of production (labor, "tangible" capital, land, etc.). The distinction is clouded by the inclusion of income from rights associated with the ongoing concern of an enterprise in the narrow category. But for our purposes, the distinction and its importance are necessarily understood in the context of the role of ("global") "intangible income" in the century-old regime of the "international tax system" in general and transfer pricing in particular.

B. The 1930s and the original "separate enterprise" standard.

It is (by now) and oft-told if not hackneyed tale, but we begin with the story of the emergence of the "international tax system" in the 1920s.[32] World War I witnessed the advent of high income and

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[31] In any event, when we talk about "intangible income" or "intangible property," we exclude property and income which sometimes are (properly) described as "intangible," simply because they are not tangible, that is, property like securities, commercial paper, notes and other debt instruments, and the like.

[32] For the original contemporary description of the tale, *see* H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 COL. J. TRANSNAT'L L. 359 (1981). The story is further elaborated in Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 625 (1986)
[hereinafter *Myth*]. For later (more reified) descriptions, *see* Michael J. Graetz & Michael M. O'Hear, *The 'Original Intent' of U.S. International Taxation*, 46 DUKE L.J. 1021, 1022–28 (1997); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301 (1996);

corporate income taxes in a wide range of jurisdictions, and in the immediate postwar period, the International Chamber of Commerce ("ICC") and the businesses it represented sought measures to curtail "double taxation"—*i.e.*, the imposition of taxes on the same tax base by two or more jurisdictions. The Financial Committee of the League of Nations ("League"), at the urging of the ICC, took up the problem. Early on, League materials articulated a concept of the "economic allegiance" of income and a principle that taxing rights should be assigned to the state to which the *tax base* in question—income in the case of income taxes—owed primary "economic allegiance."[33]

After eight years of work, the Committee devised certain "model double taxation conventions" for adoption on a bilateral basis by pairs of states. For the basic problem—taxation by one state on the basis of residence or domicile of the taxpayer, and by the other on the basis of the source or origin of the income—the principle adopted by the League is called the "classification and assignment" system: income is "classified" by category and then "assigned" to either the "residence" or "source" state. Crudely expressed, as summarized by one contemporary commentator,[34] this meant that "portfolio" income—from portfolio investment—was primarily to be assigned to the state of the taxpayer, while "direct investment" income—principally income from active business or real estate—was

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Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX. L. REV. 259 (2003); Langbein & Fuss, *supra* note 7, at 286–310. For views a bit at odds with what appears to be the consensus description, *see* Michael P. Devereux & John Vella, *Are We Heading Towards a Corporate Tax System Fit for the 21st Century?*, 35 FISCAL STUD. 449 (2014); Bret Wells & Cym H. Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 COL. J. TAX LAW 1 (2013); *cf.* H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the 'International Tax System'*, 53 TAX. L. REV. 137, 164 (2000).

33 League of Nations Economic and Financial Commission, Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, *Report on Double Taxation submitted to the Financial Committee Economic and Financial Commission*, E.F.S.73. F.19 (April 5, 1923), reprinted in 4 JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, LEGISLATIVE HISTORY OF UNITED STATES TAX CONVENTIONS (1961) at 4003 [hereinafter *Conventions Legislative History*]; *see also* Langbein & Fuss, *supra* note 7, at 286–94.

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

assigned to the state of the "origin" of the income. These conventions also developed elementary "tie breaker" rules to address the problems which arise when the two states both claim a right to tax a taxpayer on the basis of the taxpayer's domicile or residence.[35]

Left unaddressed was the question where two states might claim to tax the same income because both claimed to be the source or origin of the income. This involved primarily the income earned by single enterprises operating across borders—the question of allocating the income of corporate groups. The League addressed this question in the early 1930s. Its work posited two basic approaches—a "separate enterprise" approach or a "formula apportionment" approach. Under the former, the integrated enterprise was hypothesized to comprise a group of separate enterprises, and the tax base allocated to each was determined by the profit that would be earned by the hypothesized separate enterprises. Under the latter, the integrated profit of the enterprise was determined and then was to be allocated on the basis of certain defined factors or benchmarks. The work of the League favored the former; so the "separate enterprise" standard was ultimately incorporated into the model conventions and became the dominant standard in actual bilateral conventions negotiated on the basis of the models.[36]

The 1930s work of the League recognized a significant difficulty with the separate enterprise standard, however. This was that the total profits of the hypothesized separate enterprises might not sum to the amount of the integrated profits—there might be a shortfall. This recognition of a "residual" constitutes an early identification of ideas now associated with "intangible income." The sponsors of the

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[35] League of Nations, Double Taxation and Evasion Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, League of Nations Document C.562.M.178.1928.11 (Oct. 1928), reprinted in *Conventions Legislative History*, *supra* note 33, at 4151–94.

[36] The conclusions of the League work in this regard are set forth in Mitchell Carroll, Taxation of Foreign and National Enterprises (Volume IV) Methods of Allocating Taxable Income, League of Nations Document No. C.425(b).M.217(b).1933.11.A (Sept. 30, 1933) [hereinafter *1933 Carroll Report*]. The work and recommendations of the Carroll report are set forth at 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*, *supra* note 33, at 4243-47; *see generally* Langbein & Fuss, *supra* note 7, at 294–310.

separate enterprise system suggested a solution to this difficulty: the "residual" should be allocated, in full, to the country of the "home" or "parent" enterprise of the group. The justification given for this is that the managerial competence and strategic direction attributable to the parent enterprise was the true source of the "residual" profit of the integrated group. In this light, the separate enterprise standard was reconcilable with the "economic allegiance" principle: the "allegiance" of the "residual" was to the situs of the parent enterprise.

C. The 1968 U.S. regulations and the 1979 OECD Guidelines.

In the years ensuing after the 1930s, the polities of what we now called the developed world became preoccupied with totalitarianism, of the left or right, and wars, hot and cold, and one consequence was that the development of principles of tax comity generally, and the allocation of the profits of multinational enterprises in particular, were rendered secondary if not tertiary or quaternary concerns. These preoccupations subsided after about a quarter century; by the early 1960s, and, by then, tax authorities faced a greatly changed, if perhaps surprisingly well-functioning, world economy. One feature of this new world was the considerable expansion of multinational enterprise, the vast majority of which were "based" in the United States, *i.e.,* the parent corporation was organized under the laws of the United States or one of its constituent states.

In the 1960s, concerns about the efficiency and equity effects of tax policy, in light of this expansion of United States-based enterprise, led the United States Administration to propose changes to the statutory approach to taxing those enterprises.[37] The most significant and durable part of this effort were its "transfer pricing" regulations, finalized in the latter part of the decade.[38] Although these regulations were faithful to the "separate enterprise" concept elaborated in the 1930s and embodied in model and bilateral conventions, they took an approach slightly different from that of the earlier period. In the earlier period, each separate enterprise was evaluated to

[37] *See generally Myth*, *supra* note 32, at 640–44; Langbein & Fuss, *supra* note 7, at 310–13.

[38] Allocation of Income and Deductions Among Taxpayers, 34 Fed. Reg. 5848 (Jan. 22, 1969); Allocation of Income and Deductions Among Taxpayers, 33 Fed. Reg. 933 (Jan. 22, 1969).

determine what share it would have had of the combined group profit. In the new phase, profits were to be allocated by treating the hypothesized separate enterprise and dealing with each other through hypothesized *intercompany transactions* and determining a *transfer price*—the price that would be charged between the two enterprises, conceived as separate, in the hypothetical intercompany transaction.[39]

The regulations established rules for five categories of intercompany transactions—lending of money; performance of services by one company for the benefit of the other; the leasing of tangible property; the licensing *or* transfer of *intangible property*; and the transfer of tangible property.[40] The rules with respect to the fifth of these categories—transfer of tangible property—were by far the most significant. The new regulations introduced the concept of "methods" of determining the "transfer price" and defined three methods. The first was the "comparable uncontrolled price" method, under which the price in a transaction between "uncontrolled" parties, *i.e.*, parties not under common control, that was *comparable* to the "controlled" transaction in question, and that price (subject to adjustments) became the transfer price. The second was the "resale price method," to be used if no comparable uncontrolled transactions could be identified, under which a comparable "resale" transaction was identified, and the *margin* of the downstream party in that transaction was used (again subject to adjustments) to determine the transfer price in "controlled" transaction. The third method was

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39 *See* Langbein & Fuss, *supra* note 7, at 314–16.

40 This categorical schema remains in the regulations in force today; although the structure is more opaque, the rules are greatly more complicated. The lending rules, originally placed at Treas. Reg. § 1.482-2(a), remain with the same citation, as do the rules governing the use of tangible property (the leasing rule), at Treas. Reg. § 1.482-2(a). The services rules, originally placed at Treas. Reg. § 1.482-2(b), remain there in small part, but the rules governing the methods used in services allocations are at Treas. Reg. § 1.482-9. The transfer of intangible property rules, originally placed at Treas. Reg. § 1.482-2(d), are now Treas. Reg. § 1.482-4, although the pre-1993 rules remain as Treas. Reg. § 1.482-2A(d). Similarly, the transfer of tangible property rules are now Treas. Reg. § 1.482-3, although the pre-1993 rules remain as Treas. Reg. § 1.482-2A(e). The latter two provisions (Treas. Reg. §§ 1.482-3 and -4) are supplemented by Treas. Reg. §§ 1.482-5 and -6. governing, respectively, the comparable profits and profit split methods, which were newly added in the 1990s.

the "cost-plus" method, under which the downstream seller/producer's costs were determined; a comparable "resale" transaction was identified; and the *markup* of the downstream party in that transaction was used (again subject to adjustments) to determine the transfer price in "controlled" transaction.[41]

This schema presents the root of the ambiguity in the concept of "intangible income." In the first place, the conception of the "transfer price" at least implicitly denied the reality or even the possibility of a "residual": the implication was that the transfer price, once determined, *definitively* allocated *all* of the income of the integrated group. The regulations mitigated this hard stance in slight ways, such as by providing for unspecified "fourth methods" if none of the first three could be made workable.[42] But this created the invitation, if a residual showed up under analysis, to assume the residual was allocable to some kind of "intangible property," irrespective of whether anything genuinely recognizable as "property" could be identified. In the second place, the regulations were silent on how to handle what is, evidently, the predominant form of economic "transfer" that takes place within an integrated multinational group, viz. where there is a transfer of "tangible" property, where the value of the property is attributable to technology or trade value "embedded" in the tangible property transferred. This occurs, for instance, where a pharmaceutical company transfers a product which embodies a patent or protected secret, or a soft drink producer transfer formula embodying both a secret process and a license to market it under a globally recognized trade name. The question was whether there should be one transfer price determined in the situation, on the one hand, or two or more, on the other. If the former, the determination would be made under the tangible property transfer rules with the presence of the intangible value treated as a factor in determining whether "uncontrolled" transactions were comparable, or whether adjustments needed to be made. If the latter, a determination would

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[41] These methods remain in the regulations, in modified form. Treas. Reg. § 1.482-3(b) (comparable uncontrolled price), (c) (resale price), (d) (cost-plus). The pre-April 21, 1993 antecedents are at Treas. Reg. § 1.482-2A(e)(2)(3), and (4) (pre-April 21, 1993).

[42] *See* Treas. Reg. § 1.482-2A(e)(1)(iii) (pre-April 21, 1993). The descendants of this curious rule survive in the regulations currently in force. Treas. Reg. §§ 1.482-3(e), 1.482-4(d) ("unspecified methods").

be made under the tangible property regulations as if the product were simply the material transferred without regard to the effect either of special assembly or special branding; and separate determinations would be made with respect to each element of intangible property "embedded" in the thing transferred. The silence of the regulations on this point would greatly aggravate the tendency to make the determination under the first method, which would virtually guarantee generating a "residual," and then to assume the "residual" was related to "intangible property," without ever specifying what the intangible property was.[43]

Whatever its apparent failings, over the decade following the introduction of these regulations, the United States Treasury and the global business community succeeded in convincing virtually all affected parties—the tax authorities in both developed and developing states; international organizations; and world trade bodies—that the rules represented not only *an* appropriate but *the only* appropriate application of the treaty-based "separate enterprise" rule.[44] Rules reflecting those of the United States regulations were adopted by the OECD in 1979 as the first version of the Guidelines.[45] In the intervening time, however, there was one development of great importance not so much for its effect on the law as for its impact on transfer pricing discussion internationally. As noted, in the 1930s, the League work had begun by postulating two fundamental approaches to allocated cross-border income of integrated enterprises—a separate enterprise and a formula allocation approach.

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[43] The regulations promulgated in 1994 and in force today set forth provisions to address this problem, Treas. Reg. § 1.482-4(e), which they do quite imperfectly.

[44] Most influential in this regard was a 1971 report, summarizing individual country reports, to the International Fiscal Association, reported by Professor Stanley Surrey, who had been the Assistance Secretary of the Treasury for Tax Policy during the entire period of the Kennedy-Johnson Administration (1961-69), and his principal international tax assistant at Treasury (what is now the International Tax Counsel), David R. Tillinghast. Stanley Surrey & David Tillinghast, *General Report, Criteria for the Allocation of Items of Income and Expense Between Related Companies*, 56b CAHIERS DE DROIT FISCAL INTERNATIONALE I/1, I/12-13 (1971); *see also Myth*, *supra* note 32, at 646–51; Langbein & Fuss, *supra* note 7, at 316–18.

[45] ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (1979).

And while the international community had adopted the former for use among nations, the states of the United States adopted the latter for use among themselves. With the expansion of international commerce in midcentury, the state governments in the United States expanded the use of this method to include the foreign income of the enterprises in their allocation formulae. This triggered severe objection from the affected enterprises, and a broad coalition of foreign business, domestic business, foreign governments, and the Federal Treasury sought to prevent the states from using the formula methods, by treaty, Federal legislation, or court ruling. When all of these failed, the matter was finally resolved by compromise in the mid-1980s.[46]

But the upshot of what eventuated as a long and bitter dispute was a lingering sense that "formula apportionment" was somehow an illegal or off-color approach, and the "arm's length" standard was by contrast the "international norm." This elevation of "arm's length" was ahistorical and misleading in two important respects. First, as emphasized here, the original "separate enterprise" standard involved hypothesizing the separate components of the enterprise as independent and determining what their separate profit would be. But the notion of doing so by constructing intercompany transfer prices through hypothesized but "delineated" transactions was largely the product of the latter day 1960s regulations. And the "arm's length" idea was slightly different from the "separate enterprise" standard in that the former involved hypothesizing that the separate enterprises were dealing with each other at "arm's length."

Second, the course of development following the 1960s regulations involved some degree of departure from, if not, indeed, infidelity to, the underlying "economic allegiance" principle undergirding the entirety of the international system. As noted, in its original form, the separate enterprise standard conceded the existence of a "residual" and justified accordingly the right to tax it to the home or parent state. That may or may not be a valid application of the economic allegiance principle, but at a minimum it concedes the importance of devising allocation rules that conform to that principle. The consequence of the elevation of the "arm's length" idea in this

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[46] On the controversy over the states' use of formula apportionment, *see Myth*, *supra* note 32, at 625–28 and sources there cited; Langbein & Fuss, *supra* note 7, at 317.

period, however, was not only to imply ignorance of the potential for a "residual"; it elevated the "arm's length standard" and its supposed status as an "international norm" to be the end in itself, irrespective of its consistency with the overarching principle of economic allegiance. This becomes an element of what I have elsewhere called "cognitive capture"[47]—called "soft capture" by some[48]—where the idea takes hold which, though disputable or even demonstrably perverse, begins to dominate policy irrespective of its merits, and without continuing evaluation of either its merits or its origins. It is the first instance of such we shall identify in this narrative; we shall discover others, and they have a significant effect on international progress going forward.

II. TRANSFER PRICING WARS AND "CONTRACTUAL TERMS"

A. The 1986 tax reform.

The broad consensus about the "arm's length" standard cracked in the mid-1980s, at least in the United States. The United States had embarked on a serious program of reducing tax rates in the early 1980s, which culminated in the enactment of the Tax Reform Act of 1986,[49] which greatly reduced both corporate and individual tax rates in a "revenue neutral" statute that simultaneously enacted numerous measures broadening the tax base. The Congress considered including transfer pricing reform among the base broadening measures, but in the end refrained from doing so, although the Committee Reports on the statute set forth an explicit directive to the Treasury to conduct a study of what the Congress recognized as the serious deficiencies of existing transfer pricing law and practice.[50] The Treasury completed this study in 1988 and plainly recognized

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[47] Stanley I. Langbein, *Cognitive Capture, Parliamentary Parentheses, and the Rise of Fractional Apportionment*, 39 TAX MGM'T INT'L J. 567, 580–81 (2010); Willem H. Buiter, *Central banks and financial crises,* 104, 106 (Sept. 14, 2008) (unpublished manuscript), available at http://www.willem-buiter.com/hole.pdf (setting forth theory of "cognitive regulatory capture").

[48] Gangl et al, *Coercive and legitimate authority impact tax honesty: evidence from behavioral and ERP experiments*, 7 Soc. Cogn. Affect. Neuroscience 1108–17 (July 12, 2017).

[49] Tax Reform Act of 1986, Pub. L. No. 99-514, 109 Stat. 2089 (1986).

[50] H.R. Conf. Rep. No. 99-841 at 11-638 (1986).

the problem that the existing regulations did not determinately allocate the entire income of an integrated group.[51] It relied on academic literature making this point, literature sharply critical of the "arm's length standard" conceived as described above.[52]

Aggravating this circumstance were press reports about transfer pricing abuses. The United States monopoly on housing multinational enterprise had long since dissolved, and by the mid-1980s, the globe was populated by large and successful global enterprises based in Europe and Japan, and even some whose home was in emerging economies like South Korea, Taiwan, or Israel. These Japanese enterprises had become volume exporters of products such as automobiles and electronic equipment to the United States. Press reports in the late 1980s revealed that some of these exports, particularly but not only the Japanese, were reporting and paying shockingly low rates of corporate income tax.

B. The White Paper.

The Treasury's 1988 "White Paper," the report issued in response to the congressional directive, had suggested supplementing the three "methods" of the 1960s regulations with two additional ones. The first would have measured directly the profits of subsidiaries in a jurisdiction and compared it to those of "comparable" entities in that jurisdiction; the Paper called this the "basic arm's length return method."[53] The second would have determined the residual and split on some unspecified basis; the paper called this the profit split method.[54] These methods would be used to generate a "transfer price," but it was apparent that such a price would have little if anything to do with any *comparable transaction*. These features of the report triggered opposition in foreign countries, which found them incompatible with an "arm's length" principle which presupposed constructing transfer prices on the basis of *comparable transactions*, not *comparable profits* or *comparable results.* The Europeans called the White Paper's proposals "profits methods," and contrasted them with the three methods received from the 1960s, which they called

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[51] UNITED STATES TREASURY DEP'T, A STUDY OF INTERCOMPANY PRICING 182–83 (1988) was issued as Notice 88-123, 1988-2 C.B. 458.

[52] *Id.* at 122–24 citing *Myth* (discussing the "continuum price problem").

[53] *Id.* at 65.

[54] *Id.* at 160–61.

"transactional methods." Oddly, the two sides were in some sense in switched positions from the sides that had obtained the 1960s, when the United States introduced in concrete form the approach of constructing transactions and determining "transfer prices" from actual comparable prices: the White Paper suggestions harkened back to the elementary ideas of the 1930s and 1940s, which seemed to accept the process of determining the income that would be allocated to an enterprise independent of the group by examining the enterprise's operations in their entirety.

C. Revised U.S. Regulations.

The United States published proposed regulations in early 1992,[55] which implemented in part the White Paper proposals, and these triggered concern and opposition in foreign business and official circles. The OECD convened a task force to comment on the United States proposals and to formulate amendments to the 1979 Guidelines.[56] Working behind the scenes with foreign powers, the United States issued new temporary[57] and proposed regulations in 1993;[58] these would form the core of the new regime, both of the revised United States regulations and the revised Guidelines.

These regulations, made final in 1994[59] and 1995,[60] set forth the two new "profit methods" derived, though greatly modified, from the White Paper—the "ballroom method" now called the "comparable profits method,"[61] and the profit split method divided into two parts, a "comparable profit split" method and a "residual profit split"

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[55] INTL-372-88 INTL-401-88, 57 Fed. Reg. 3571 (Jan. 30, 1992).

[56] *See* Langbein & Fuss, *supra* note 7, at 323; Organization for Economic Cooperation and Development, Committee on Fiscal Affairs, OCDE /GD(93)131, *Intercompany Transfer Pricing Regulations Under U.S. Section 482 Temporary and Proposed Regulations*, http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=OCDE/GD(93)131&docLanguage=En.

[57] TD 8470, 58 Fed. Reg. 5263 (Jan. 21, 1993).

[58] 58. Fed. Reg. 5310 (Jan. 21, 1993).

[59] TD 8552, 59 Fed. Reg. 34,971 (July 8, 1994).

[60] TD 8632, 60 Fed. Reg. 65,553 (Dec. 19, 1995) *superseded by* TD 9568, 76 Fed. Reg. 80, 882 (Dec. 22, 2011).

[61] The regulations governing this method, promulgated in 1994, remain in force today as Treas. Reg. § 1.482-5.

method.[62] But the key element of the new regulations was an articulate definition of the "comparability" of an uncontrolled transaction or entity to be determined irrespective of which of any of the now five available methods was used.[63] This definition set forth a five factors to be examined in connection with determining when transactions or entities were "comparable": functional analysis; "contractual terms"; risk; property; and economic conditions.[64] Of these, only one, the last, involved matters external to the parties examined; the others concerned the operations of the tested "controlled" groups and the external "comparable" group. The idea was that one applied these factors to the group under examination (the taxpayer), then found an external "uncontrolled" group, which, when examined, most resembled the taxpayer group with respect to the five factors. Then, theoretically, one used the "comparable price" charged between the members of the external group (in the case of the comparable uncontrolled price method), or the reseller-margin (resale price method), producer markup (cost-plus), or profit measure (comparable profits), or profit division (profit split), to determine the "transfer price" to be charged between the uncontrolled parties in the taxpayer group.

Above we drew a distinction between the approach of the 1960s regulations (and 1979 Guidelines), which cast the objective of examination as determining a "transfer price" under a series of prescribed methods; and that suggested by the earlier documents of the 1930s and 1940s, which viewed the effort as determining an allocation of profits, with the determination of a comparable price the only pricing method, to be supplemented in the wide range of instances in which it was contemplated that such a determination would not be possible. An interesting feature of this third iteration of transfer pricing rules is that it in ways combined the two approaches. It was faithful to the "pricing" technique, on the surface, because the comparability examination was to serve in the selection of a benchmark to be used in connection with a method, and the method ultimately determined a "price." But it resurrected the direct-allocation approach because the complex and articulate comparability analysis in

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62 The regulations governing this method, promulgated in 1994, remain in force today as Treas. Reg. § 1.482-6.

63 Treas. Reg. § 1.482-6.

64 Treas. Reg. § 1.482-1(d).

itself reflected if it did not constitute such an approach. In particular, the triple functional analysis/property/risk examination adumbrates in a ghostly way the property/payroll/sales approach of the formula apportionment method historically used by the American states;[65] and once one thoroughly considered those features of a controlled group operation, one could make an allocation on that basis, without the need for replicating the analysis with respect to a "comparable" group, and indeed without the importation of a price/margin/markup/profit indicator/profit split to determine a "price."

This intuition proves to be prescient about what experience would be under this transfer pricing *drittes Reich*. The setup of the rules tended ineluctably to undermine the notion that the exercise was to determine a "price" based on the use of "methods" and "comparables"; but rather to determine an allocation based on "functions, assets, and risks," a triad the OECD materials would repeat so steadily that a leading commentator would refer to the references as "jargon."[66] But, given this, there was one circumstance which undermined further the notion that the comparability determination would be the result of an honest consideration of these three aspects of the production process. For there was a fourth factor about the internal operations of the controlled group which was given a prominent place in the comparability determination and that was, of course, contractual terms. Ostensibly, contractual terms were but an element of the comparability determination: the idea was that one should find an "uncontrolled" set of parties which set terms between the parties that resembled or approximated the terms set forth between the controlled parties, often in their formal intercorporate agreements. But the pattern suggested above—of the comparability determination

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[65] The parallel between "assets" and "property" is straightforward. That between "payroll" and "functions" is not exact, but functional operations, particularly if examined as distinct from assets and risks, would ordinarily implicate in some proportional manner the volume of payroll. The link of "risks" to "sales" is the most obscure of the three, but is clearer if one bears in mind that throughout its discussions of risk, most particularly in the later stages of the BEPS report, *see* part IV *infra*, the OECD tends to see risk not narrowly as the threat of loss, but more expansively as a synonym for what might be called profit opportunity. Hence risk in this sense might follow the volume of sales.

[66] Richard J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 WORLD TAX J. 291, 326 (2010).

degenerating into a direct allocation rather than a preliminary element of the determination of a "price"—operated as much with respect to this factor as it did with respect to the other three or four.

And two further, also foreseeable, tendencies operated to create a highly problematic set of consequences. First, because "contractual terms" were concrete and visible, and functions/assets/risks were nebulously defined and subject to innumerable ambiguities, "contractual terms" came to be the *dominant*—and, in later years, sometimes the sole—factor examined in connection with the "comparability" determination. Although neither the regulations nor the Guidelines were entirely clear in mandating this, the "contractual terms" criterion came to be both a *presumption* and a *first step* in the comparability analysis: the intercorporate contract were the reference by which it was determined *which* functions, risks, and assets were attributed to *which* component of the group. That task is exceedingly difficult in a group of nominally separate corporations typically operating as a unit; but the terms of intercorporate contract could be centrally controlled and made absolutely clear. Second, and this was the vicious step in the process, although it clearly reinforced the other steps, the elevation of "contractual terms" gave extraordinary discretion to the taxpayer itself to determine the outcome of the whole process, and in particular, to determine the situs of the "residual" income.

This is in fact what occurred. And this meant that with the three successive transfer pricing regimes, there were three distinguishable approaches to the taxation of the "residual:" in the 1930s regime, the contemplation was largely that the residual would be allocated to the "home" jurisdiction of the parent of the group, on grounds that the functioning of the headquarters was the source of the residual profit. In the 1960s regime, the residual was indeterminately assigned; the matter depending first on the selection of the "method" to be used, but second on the discretion of the examining authority. But under either of these regimes, the residual could still be taxed at source. In the *drittes Reich,* the residual was to be taxed by whichever state was selected by the taxpayer group. That was a formula for trouble.

D. Revised OECD Guidelines and "contractual terms."

In 1995-96, the OECD issued its second (first revised) version of its Guidelines.[67] As the 1979 Guidelines had closely followed the 1968 United States rules, these revisions closely followed the 1993-94 United States rules, although the OECD's demurrals to and departures from the United States predecessor were substantially greater than any the organization had expressed seventeen years earlier.[68] In particular, the Guidelines set forth a far more restricted role for the comparable profits method, which the OECD calls the "transactional net profits method" ("TNPM"), than contemplated by the United States regulations.[69] But the OECD Guidelines adopted the complex definition of comparability, accepted the five factors listed in the United States regulations, and emphasized the role of "contractual terms."[70] This set the stage for what occurred.

This dominant role of "contractual terms" interacted with the "methods" in a destructive way. It had been recognized long before the promulgation of the revised regulations and Guidelines that what I had called the "single-component" methods,[71] what the OECD now calls the "unilateral" or "one-sided" methods—the resale price and cost-plus methods of the 1960s regime, joined by the comparable profits method of the new rules—were methods that did not definitively allocate the entire income of the group. After several applications of these methods to the various components of the group, one would be left with the "residual." If contractual terms determined the final allocation, and if the unilateral methods were permissible approaches, the "controlled" parties could devise contracts which allocated only "marginal" income to both a state where property was "produced" (or services "performed") or the state where the property or services were "sold" or "distributed;" with the "re-

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[67] ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (1995) [hereinafter *1995 Transfer Pricing Guidelines*].

[68] On these differences in detail, *see* Langbein & Fuss, *supra* note 7, at 331–36.

[69] *1995 Transfer Pricing Guidelines*, *supra* note 67, ¶¶ 3.26-3.57.

[70] *Id.* ¶¶ 1.15-1.35. The 1995 version did not include "risk" as one of the five factors, but instead included "business strategies." This was changed in the 2010 version of the Guidelines.

[71] *See Myth*, *supra* note 32, at 628.

sidual"—the lion's share of the total group income—shifted, instead, to an interposed third "base country," ordinarily a low-tax "tax haven" with little economic connection to the income producing process.

The situation was aggravated further by the "developer-assister" concept, born during the process of developing the 1960s regulations in the United States,[72] carried over in both the final 1968 and 1994 regulations[73] and in the OECD Guidelines in 1979 and 1995-96. Under this principle, one component of a group could be designated the "developer" of intangible property, with the others treated as "assisters;" but no income was to be allocated to any of the "assisters" until and unless the intangible property in question was finally developed and placed in service. The rule obviously facilitated the concentration of "residual" income in a central party organized in a low-tax jurisdiction. Thus, the residual could be directed to a low-tax jurisdiction.

And these opportunities were magnified by the confusion, articulated above, in ideas about "intangible income." If it were assumed that intangible income meant the residual, and that intangible income necessarily meant *income attributable to identifiable intangible property*, that conception facilitated the process by which multinational enterprises, particularly in industries like pharmaceuticals or technology, could allocate by "contractual terms" the "residual" to "tax havens." Those enterprises would ordinarily possess valuable and identifiable intangible property, and they could by intercorporate contract assign "ownership" of this property to the tax haven subsidiary. If the entire residual were assumed to be income from "the intangible," this would mean the entire residual was reposed in the tax haven. A different situation obtained if the intangible property were conceived as a factor like any other, to be allocated a "marginal" return, and the "residual" were understood to be income attributable to the fact of organization itself and not to any particular income producing factor.[74]

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[72] The rule appears, as applicable to pre-April 21, 1993 transactions, at Treas. Reg. § 1.482-2A(d)(1)(ii).

[73] The rule is reflected in the rule of the present regulations governing ownership of intangibles. Treas. Reg. § 1.482-4(f)(3).

[74] *See* Langbein & Fuss, *supra* note 7, at 320–21.

Ultimately, however, this practice meant that the actual operation of the rules devised in the 1990s made a mockery of the supposedly overarching principles of "independent enterprise" dealing at "arm's length." If the independent enterprise were a producing/performing arm, on the one hand, and a distributing/purchasing arm, on the other, and their joint operation produced a sizable "residual" profit, it would seem the *last* thing they would do would be to seek out an "independent" third party intermediary to which they would shift, and in which they would accumulate, the major part of their jointly profitable operations.

In any event, this structure was increasingly used to shield corporate income, especially in technology-intensive industries, from taxation on the basis of source in any country other than its parent country. This was phenomena responsible for the large accumulations of cash in foreign countries, particularly low-tax countries, witnessed in the first twenty years of the twenty-first century. These accumulations were in turn largely responsible for the intense pressure by the multinational community to enact "territoriality" and "repatriation," both of which were enacted by the TCJA. When these large accumulations are repatriated under those provisions at reduced rates of tax, they will be returned having been barely taxed by any country at all, although any number of nations may have had a claim to tax it. The situation attracted the attention of the OECD very soon after the revisions of the 1990s were finalized. Over time, the OECD became increasingly concerned about the situation. The United States did not.

III. LE CĐTE OCDE

A. Permanent establishments.

The OECD Model Convention, like all of its predecessors since the 1930s, has two provisions premised on the "independent enterprise" standard. Article 9 governs relations established between "associated enterprises."[75] This applies where an enterprise of one contracting state operates in the other through a separately formed or

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[75] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, MODEL DOUBLE TAXATION CONVENTION ON TAXES ON INCOME AND CAPITAL, art. 9 (2010).

incorporated enterprise. Article 7 governs relations between an enterprise of one contracting state and a *permanent establishment* ("PE") situated in the other.[76] This governs where the enterprise in the first contracting state operates in the other, but does not do so through a separately incorporated entity, but rather through a branch of the home state entity. The latter form of doing cross-border business is most common in the banking industry, and some other financial service businesses, but far less common outside the financial sector.

The original work in the 1930s did not distinguish too sharply between the two contexts. As noted, it was based on primary reliance on "comparable uncontrolled prices," backed up by allocation methods, as opposed to pricing methods, and contemplated this approach both with respect to the associated enterprise and PE contexts. The expansion of multinational corporate activity in the period following World War II was effected primarily through the formation by "home" countries of separate legal entities in "host" states. Reflecting this, the United States regulations were effected under Section 482 of the Internal Revenue Code, which confers authority on the Internal Revenue Service to reallocate income among separate enterprises under common control. It does not concern cross-border branching, which is governed largely by the rules governing source of income and allocation of deductions, both with respect to "outbound" branch operations (foreign branches of United States persons) and the "inbound" (United States branches of foreign concerns).

Because the 1979 OECD Guidelines so closely followed the lead of the United States, those Guidelines were concerned primarily with the Article 9 "associated enterprises" context. This pattern held in the early 1990s when the United States reformulated its regulations, and the OECD reformed its approach, for the most part accordingly. Thus, the Article 7 context was not governed by the transfer pricing concepts which by the end of the century had become well entrenched, notwithstanding that identical treaty language governed both contexts.

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[76] *Id.* at art. 7.

B. The AOA.

Early after the turn of the century, this changed, as the OECD established elaborate principles to govern the Article 7 context, based roughly, but with critically significant differences, on the Transfer Pricing Guidelines.[77] These principles were embodied in what the OECD called the "authorized OECD approach," or AOA, finalized in 2010. The interlude in which these principles evolved is important for our purposes for three major reasons. First, the development of these rules represented the first occasion on which the OECD took the initiative without any prodding from the United States, and which it developed principles that were not based on previous United States rules (and which the United States would not follow even after those principles were finalized). Second, the substance of the OECD's approach reflected very clearly that throughout the OECD was aware of and concerned about the "degeneration" of the 1995-96 transfer pricing rules. And it is significant that the OECD's consciousness of the problem long predated the press reports, European Union actions, and hearings in the United States Congress that would highlight the difficulties and lead ultimately to BEPS. Third, certain particular facets of the final approach adopted by the OECD form the basis of principles the OECD would apply in the transfer pricing context, first in the revision of the Guidelines in 2010, and later in the revision in 2015-17 developed in connection with the BEPS initiative. The latter two matters need detain us but a bit.

At the outset of its AOA project, the OECD made clear it would not be bound by, to use Brett Kavanaugh's oft-repeated if mildly unctuous phrase, "history, tradition, and precedent": the Justice's project was not to be "constrained" by "the original intent or the historical practice and interpretation of Article 7"; instead "the focus was on formulating the most preferable approach . . . given modern-

[77] The OECD's development of these rules began with a Discussion Draft published in 2001, although its internal consideration of the matter had begun somewhat earlier. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (2001), http://www.oecd.org/ctp/transfer-pricing/1923028.pdf. The various drafts of the final version of the report are cited, and the progress of the project reviewed in detail, in Langbein & Fuss, *supra* note 7, at 341–50.

day multinational operations and trade."[78] But in stepping out from the past, the AOA's most critical step was in rejecting the use of "contractual terms" or any analogue of it in the PE context. The OECD's stated reason for this departure from the Guidelines was that, among associated enterprises, "the determination of which enterprise owns assets and which bears risk is determined by legally binding contracts or other ascertainable legal arrangements . . . providing those contracts or legal arrangement reflect the underlying reality and meet the criteria in Chapter I of the Guidelines," while "[t]he factual, legal position in a PE context . . . 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." But 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 was "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 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."[79]

Two salient points may be made. First, this passage comes closer than anything in the Guidelines or the United States regulations to conceding what the actual role of "contractual terms" had become: as both a presumption about the ultimate profit allocation, and a first—and near determinative—step in the course of the functional or "comparability" analysis that was purportedly to follow. Second, the passage exhibits without expressing concern by the OECD with where practice under the 1993-96 innovations was heading. As a colleague and I have noted elsewhere, this passage both overstates the difference between the associated enterprise and PE contexts and

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78 ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, 2010 REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS, ¶ 3, at 11 (July 22, 2010).

79 *Id.* ¶ 17, at 13–14.

unduly deprecates the feasibility of employing an analogue to "contractual terms" in the latter context.[80] As to the first point, intercorporate contracts in a commonly controlled group are really enforced only where one or more of the controlled parties is dealing with an uncontrolled party; the identification of "functions, risks, assets" with particular component enterprises can be no less challenging where the components of an enterprise are legally separate as opposed to where they are not. Nor is there any reason to be sanguine or complacent about the task of determining whether "contracts" comport with "underlying reality," the "actual conduct" of the parties, or the criteria of Chapter I. As to the second, most enterprises operating through branches keep separate books and accounts for separate branches—often they are required to do so—and there is little reason why these accounts could not be used as a starting point in siting "functions, assets, risks" among various components of an enterprise. This technique is precisely that used in certain U.S. Treasury regulations governing foreign banks with U.S. branches.

For these reasons, the conclusion is ineluctable that a principal motivation for the limitation of any taxpayer-determined starting point in the PE context was the organization's emerging consciousness of where the use of that technique under the Guidelines was tending—and a determination to staunch the spread of problematical practices and results.

The second point concerns what the AOA devises as a substitute for "contractual terms" in localizing "functions, assets, risks." Given that it was "not possible to use a legal analysis as the required mechanism, another solution must be sought," and the AOA found this in an analysis of "people functions:" the AOA "attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) or 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 are performed by people in the PE."[81] The Report on the Attribution of Profits to Permanent Establishments says that "the significant people functions relevant to the assumption of risks are those which involve active decision

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[80] Langbein & Fuss, *supra* note 7, at 345–46.

[81] *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* note 78, ¶ 18, at 14 (footnote omitted).

making." Under this formulation, risk reposed where it was managed, irrespective of where it posed a risk of loss. Thus, capital followed risk, 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 those risks."[82]

This association of risk with the place where it is managed—later "controlled"—would be revisited by the OECD subsequently, particularly in the final BEPS reports (and, thus, the 2015-2017 revisions of the Guidelines). The relationship of the place of management or control to the place whose capital might be jeopardized by a risk would have to be refined, if not changed, by later work.

C. The Restructuring Report (Guidelines Chapter IX).

Midway through the period when the AOA was evolving, the OECD made a more frontal assault on the "contractual terms" regime, without suggesting any change in the provisions of the Guidelines that fostered that regime. Instead of attacking directly the role of contractual terms in routing income to "central" subsidiary "developers," the OECD chose instead to limit such allocations by devising new rules aimed at the *transactions* by which such parties became central. And, in contrast to its performance in the AOA documents, the organization did not entirely conceal dissatisfaction with existing and emerging practices. Early in the process of devising the restructuring rules, the OECD conceded it had discerned "since the mid-90s" a "common pattern" of international business organization, without regard to the industry sector, becoming "more centralized," with intangible assets and risks which had been "previously integrated in local operations" transferred to "more centralized and specialized regional or global units," with revenue authorities "seeing reduced profits being generated in their jurisdictions as a result."[83] The OECD conceded that there existed "no legal or universally accepted definition of business restructuring," but offered for working purposes the definition as "the cross-border redeployment by a multinational enterprise of functions, assets and/or risks,"

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[82] *Id.* ¶ 29.

[83] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, 2D ANNUAL CENTRE FOR TAX POLICY AND ADMINISTRATION ROUNDTABLE: BUSINESS RESTRUCTURING (Jan. 26-27, 2005).

which "may involve cross-border transfers of valuable intangibles," and which consisted primarily of "internal reallocation of functions, assets and risks within an MNE, although relationships with third parties . . . may also be a reason for the restructuring and/or be affected by it."[84]

In a 2008 Discussion Draft, the OECD identified four issues with restructuring for consideration:

- The question of the allocation of risks among commonly controlled entities, with particular reference to the allocation between central and satellite parties, post-restructuring;
- The determination of compensation to a transferring entity in connection with the restructuring itself;
- The allocation of profits post-restructuring, with particular emphasis on the allocation of profits to the entities transferring assets or other "profit potential" in the restructuring; and
- The occasion for allocation of profits post-restructuring in derogation or disregard of "contractual terms."[85]

The 2008 Discussion Draft set forth Issue Notes with respect to each of the four, and in each case introduced novel concepts, all of which curtailed the domain of "contractual terms," in each case. Only the innovations suggested with respect to the first two issues survived, however, in the final 2010 version of the restructuring report; the terms of which were adopted as Chapter IX of the revised 2010 version of the Guidelines.

With respect to the first issue, the Discussion Draft provided that the assignment of risks effected by "contractual terms" would not be respected unless the assignment had "economic substance," and that the allocation would not be treated as having economic substance unless three conditions are met: the conduct of the parties conforms to the "contractual terms"; the terms themselves are "arm's length"; and the consequences of the allocation were also arm's length. The second is the most significant, because the Draft and 2010 Guidelines provide that in determining whether the terms

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[84] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS: DISCUSSION DRAFT FOR PUBLIC COMMENT 1, 6 (Sept. 19, 2008-Feb. 19, 2009), http://www.oecd.org/tax/transfer-pricing/41346644.pdf [hereinafter *2008 OECD Restructuring Discussion Draft*].

[85] *Id.* at 3.

are "arm's length," one must find a comparable uncontrolled group if possible, and that, if not possible, one must determine whether the allocation is one which *hypothetical* comparable parties would affect. It provided further that in making the latter determination, certain factors could "assist," and the predominant factors were the allocation of "control over risk" and whether a party allocated such control had the "financial capacity to assume the risk."[86]

It then defined "control over risk" in terms suggested by the AOA: "the capacity to make decision 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," which would "require the company to have people—employees or directors—who have the authority to, and effectively do, perform these control functions." At the same time, the report cautioned that the "reference to 'control over risk' and of 'financial capacity to assume the risk/ is not intended to set a standard under Article . . . whereby risks would always follow capital or people functions," because "[t]he analytical framework under Article 9 is different from the AOA that was developed under Article 7."[87]

Nevertheless, these provisions did arm tax authorities to make reallocations in derogation of "contractual terms" in circumstances where a naked or "paper" transfer of ownership or other profit potential without change in the assignment of personnel or capital.

With respect to the second issue, the restructuring report, and Chapter IX embodying it, recognized, if implicitly, the definitional ambiguity with respect to the idea of "intangible income" noted at the outset here. It provided for a compensatory payment to the transferring entity with respect to any transfer of profit potential from the previous "full scale distributorship" to the transferee central party without regard to whether the status of what was transferred as "property" or the accounting treatment of the transfer. Thus, what was transferred or lost in the restructuring might be a loss of local synergies; an indemnification for a loss of contractual relationship, irrespective of any enhancement of group-wide synergies; a loss of

86 *Id.* at 240–42; *see* Langbein & Fuss, *supra* note 7, at 353–54.

87 *2008 OECD Restructuring Discussion Draft*, *supra* note 84, at 243–44; *see* Langbein & Fuss, *supra* note 7, at 354–55.

profit potential which was not an asset; a transfer of goodwill; or a going concern value.[88]

With respect to the final two issues, fairly extensive innovations suggested by the 2008 Issues Notes were not carried forward into the Guidelines. The third Issues Note discussed restrictions on the role of "unilateral" or "one-sided" methods (RSP, CPM, TNMM) in making post-restructuring determinations, and an elevation of the role of the profit split method, to preserve some allocation to the transferor entity.[89] The fourth discussed broadened circumstances for the "nonrecognition" of "contractual terms."[90]

D. *The Intangibles Project.*

Early in the process of producing the restructuring report, the two working parties involved agreed that the issue of the ownership of "intangibles" and the location of such ownership within a multinational group, would be excised from consideration in connection with the restructuring report, especially from the second issue (compensation of the transferor party in a restructuring). The OECD, upon the promulgation of 2010 Guidelines, announced it would take up this issue in a third effort, a project to determine the role of "intangibles" in transfer pricing generally.[91] The OECD pursued this effort to the point of issuing a Discussion Draft in 2012.[92] It did not go beyond the Discussion Draft, however, because the project was absorbed by the more general BEPS effort.

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[88] *2008 OECD Restructuring Discussion Draft*, *supra* note 84, at 21–27; *see* Langbein & Fuss, *supra* note 7, at 356–57.

[89] *2008 OECD Restructuring Discussion Draft*, *supra* note 84, at 39–40; *see* Langbein & Fuss, *supra* note 7, at 357–58.

[90] *2008 OECD Restructuring Discussion Draft*, *supra* note 84, at 52–54; *see* Langbein & Fuss*, supra* note 7, at 359–60.

[91] *See* ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING AND INTANGIBLES: SCOPE OF THE PROJECT, ¶ 1, http://www.oecd.org/tax/transfer-pricing/46987988.pdf.

[92] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, DISCUSSION DRAFT, REVISION OF THE SPECIAL CONSIDERATIONS FOR INTANGIBLES IN CHAPTER VI OF THE OECD TRANSFER PRICING GUIDELINES AND RELATED PROVISIONS (6 June to 14 Sept. 2012), https://www.oecd.org/ctp/transfer-pricing/50526258.pdf [hereinafter *2012 Intangibles Discussion Draft*].

In the Discussion Draft, Working Party No. 6 implicitly rejected the "developer/assister" notion and established a conception of "intangible related returns," saying that the Party's delegates were "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."[93]

The Discussion Draft made clear that, in contrast to the developer/assister notion, there can be more than one "developer." The Draft deprecated "contractual terms" as it repudiated "developer/assister." The Draft would not have assigned "economic ownership" of an intangible but rather the right to participate in the IRRs, which would generally follow from FAR analysis. The FAR analysis, in turn, would 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."[94] The 2012 Discussion Draft framed the test whether contractual agreements evince the necessary economic "substance" to be respected, in terms suggested by Part II of the restructuring chapter, directing evaluation of "the alignment between a contractual claim to entitlement to all or part of the intangible related returns . . . and the conduct of the parties," by examining functions, risks, and costs related to the development, enhancement, maintenance and protection of the intangibles. It emphasized that "[w]here 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."[95]

The language about the "development, enhancement, maintenance and protection," joined later by the term "exploitation" and

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[93] *Id.* at 12.
[94] *See id.* ¶ 29.
[95] *See id.* ¶ 37.

often acronymized as ("DEMPE,") would become an important element of the "jargon" of the BEPS report.

IV. BEPS

A. *The BEPS Project and Actions 8-10.*

When Congress in 1985-86 gave impetus to transfer pricing reform,[96] the initial signs, manifest in the Treasury's 1988 White Paper,[97] were that the system would be reformed to be more predictable and to restrict opportunities for abuse and tax avoidance. But what resulted in the mid-1990s was a new system, which if anything, gave greater room for abuse and avoidance.[98] Similarly, when the OECD initiated the restructuring effort in 2005, its initial document exhibited a considerably greater degree of rationality and understanding of the economics of the operations of MNEs than did the unreconstructed existing system.[99] But that reformist rationality was greatly dimmed—though not altogether extinguished—by the ultimate changes to the governing Guidelines finally adopted. A similar pattern—initial promise, snuffed out by a more corporatist policy tilt—would be repeated by the BEPS initiative.

The BEPS initiative was adopted by the G-20 in late 2012 and entrusted to the OECD as the entity with the expertise to implement the goals of the BEPS initiative. The OECD began its work with a preliminary report issued in February 2013.[100] This document articulated a "value creation paradigm." The report stressed "a growing perception that governments lose substantial corporate tax revenue

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96 H. R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 11-638 (1986) (Conference Report on the Tax Reform Act of 1986).

97 UNITED STATES TREASURY DEP'T, A STUDY OF INTERCOMPANY PRICING (1988) was issued as Notice 88-123, 1988-2 C.B. 458, 182-83.

98 *See generally* discussion *supra* Part III.

99 The OECD called it a "lively dialogue" on "accelerating changes taking place." ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, 2ND ANNUAL CENTRE FOR TAX POLICY AND ADMINISTRATION ROUNDTABLE: BUSINESS RESTRUCTURING, http://www.oecd.org/ctp/transfer-pricing/2ndannualcentrefortaxpolicyandadministrationroundtablebusinessrestructuring.htm [hereinafter *2005 Roundtable*]; *see* Langbein & Fuss, *supra* note 7, at 350–61.

100 ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, ADDRESSING BASE EROSION AND PROFIT SHIFTING (2013), http://www.fiscooggi.it/files/addressing_base_erosion_and_profit_shifting.pdf.

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,"[101] and focused upon the use of passive entities to channel foreign direct investments so that profits on those investments technically accrued to entities in low-tax jurisdictions, leading to "increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes."[102]

The report expressed dissatisfaction with the existing international tax order and eschewed the conventional vocal reaffirmation of "arm's length," suggesting 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."[103] It identified the "underlying assumptions of the arm's length standard"[104] as the cause of such "profit shifting" and explicitly found it problematic to base the determination of transfer prices on "contractual allocation of risks and intangibles."[105] The report identified "key pressure areas" and announced the intention to develop a "comprehensive action" plan with the "main purpose"[106] of providing instruments for governments to use in "better aligning rights to tax with real economic activity"[107] (*i.e.*, "elements such as sales, workforce, payroll, and fixed assets"), and which would "realign international standards with current global business environment."[108]

The report further states that achieving the goal of "better aligning rights to tax with real economic activity" and "realign[ing] international standards with [the] current global business environment" required revisiting "some of the fundamentals of the existing standards" and that "incremental approaches may help curb the current trends but will not respond to several of the challenges."[109]

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[101] *Id.* at 13.
[102] *Id.* at 20.
[103] *Id.* at 42.
[104] *Id.*
[105] *Id.*
[106] *Id.* at 51.
[107] *Id.* (emphasis added).
[108] *Id.*
[109] *Id.*

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,"[110] and also asks that the on-going discussions on intangibles be "included in a broader reflection on transfer pricing."[111]

The second step in the BEPS process was the articulation of an Action Plan, set out in a document issued three months later.[112] This document continued to express reservations about "arm's length," but exhibited considerably greater coldness than had the earlier document toward fundamental reform. The Action Plan averred that the arm's length standard in "many instances" allocates the income of MNEs "effectively and efficiently," but conceded that the standard could be "used and/or misapplied" in a way that results in "separat[ing] income from economic activity that produce that income."[113] But the *Action Plan* emphasized that "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."[114] Action Points 8-10[115] 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,"[116] and to "ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital."[117]

The third step in the process entailed the issuance of preliminary deliverables or discussion drafts in 2014 and 2015. The fourth was

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110 *Id.* at 5, 73.
111 *Id.* at 10, 52.
112 ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, ACTION PLAN ON BEPS (2013) [hereinafter *OECD 2013 Action Plan*].
113 *Id.*
114 *Id.* at 19 (emphasis added).
115 The text of these Action Points is set forth in the Appendix to the article.
116 *OECD 2013 Action Plan*, *supra* note 112, at 20, Action 8.
117 *Id.* at 20, Action 9.

the incorporation of the ideas set forth in the preliminary documents into Final Documents. In the case of actions 8-10 of the Action Plan, which concerned transfer pricing, the Final Reports were issued as a single document and most of the provisions of that document were to be adopted as amendments or additions to the Transfer Pricing Guidance. The two final steps continued the progression established by the first two: the preliminary deliverables/documents hewed closely to the established dogma, with some innovations pointing toward a reformed system, although even those innovations had largely been visited previously, in the 2008 and 2010 documents concerning restructuring, and the 2012 Discussion Draft on intangibles; the final reports blurred and minimized even this new movement reflected in the preliminary deliverables and drafts.

B. The 2014 deliverables and discussion drafts.

The preliminary documents were issued serially according to different topics, with seven pertaining to Actions 8-10 issued in all; the provisions of most of these were modified and combined in the single "Final Reports." Of the seven preliminary reports, two were of central significance: (1) a "deliverable" concerning intangible property, issued pursuant to Action 8 in September 2014;[118] and (2) a Discussion Draft concerning risk, recharacterization, and special measures, issued pursuant to Action 10 in December 2014.[119] More narrowly focused reports concerned low value-adding intra-group

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[118] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD/G20 BEPS PROJECT, GUIDANCE ON THE TRANSFER PRICING ASPECTS OF INTANGIBLES, ACTION 8: 2014 DELIVERABLE (2014), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#.WQOiXoWcGUk [hereinafter *2014 Action 8 Deliverable*].

[119] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PUBLIC DISCUSSION DRAFT, BEPS ACTIONS 8, 9, 10: DISCUSSION DRAFT ON REVISIONS TO CHAPTER 1 OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERISATION, AND SPECIAL MEASURES): 1 DEC. 2014 – 6 FEB. 2015 (2015), http://www.oecd.org/ctp/transfer-pricing/discussion-draft-actions-8-9-10-chapter-1-TP-Guidelines-risk-recharacterisation-special-measures.pdf [hereinafter *2014 Recharacterisation Discussion Draft*].

services (November 2014);[120] profit splits (December 2014)[121] cross-border commodity transactions (December 2014);[122] cost contribution agreements ("CCAs") (April 2015);[123] and hard-to-value intangibles (June 2015).[124] The Final Reports, covered all six topics except the final guidance on profit splits, were issued as a single document in September 2015.[125]

The most significant issues were addressed in the two principal preliminary documents concerning intangibles and risk recharacterization. The intangibles deliverable was published about three months before (September 2014) the recharacterization discussion draft (December 2014). Nevertheless, it is better to begin our discussion with the latter matter, for two reasons. First, although the

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[120] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PUBLIC DISCUSSION DRAFT, BEPS ACTION 10: PROPOSED MODIFICATIONS TO CHAPTER VII OF THE TRANSFER PRICING GUIDELINES RELATING TO LOW-VALUE-ADDING INTRA-GROUP SERVICES: 3 NOVEMBER 2014 - 14 JANUARY 2015 (2015), https://www.oecd.org/tax/transfer-pricing/discussion-draft-action-10-low-value-adding-intra-group-services.pdf.

[121] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PUBLIC DISCUSSION DRAFT, BEPS ACTION 10: DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS: 16 DECEMBER 2014 - 6 FEBRUARY 2015 (2015), http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-profit-splits-global-value-chains.pdf.

[122] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PUBLIC DISCUSSION DRAFT, BEPS ACTION 10: DISCUSSION DRAFT ON THE TRANSFER PRICING ASPECTS OF CROSS-BORDER COMMODITY TRANSACTIONS: 10 FEBRUARY 2015 (2015), https://www.oecd.org/tax/transfer-pricing/public-comments-action-10-cross-border-commodity-transactions.pdf.

[123] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PUBLIC DISCUSSION DRAFT, BEPS ACTION 8: REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTIONS AGREEMENTS (CCAS): 29 APRIL 2015 - 29 MAY 2015 (2015), http://www.oecd.org/tax/transfer-pricing/discussion-draft-BEPS-action-8-cost-contribution-arrangements.pdf.

[124] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PUBLIC DISCUSSION DRAFT, BEPS ACTION 8: HARD-TO-VALUE INTANGIBLES: 4 JUNE 2015 - 18 JUNE 2016 (2016), https://www.oecd.org/ctp/transfer-pricing/discussion-draft-beps-action-8-hard-to-value-intangibles.pdf [hereinafter *2015 HTVI Discussion Draft*].

[125] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD/G20 BEPS REPORT: ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION, ACTIONS 8-10: 2015 FINAL REPORTS (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.

intangibles preliminary document was published first, both documents resume the development of ideas published in earlier OECD efforts—the 2010 restructuring report and Chapter IX of the 2010 Guidelines in the case of the recharacterization effort; the 2012 intangibles report in the case of the intangibles deliverable. Our discussion follows the order in which these earlier efforts appeared. Second, the changes made in the Final Reports with respect to both issues center around changes made directly to the provisions of the risk/recharacterization Discussion Draft.

The 2014 recharacterization discussion draft made inroads on "contractual terms" in three principal ways.[126] The draft proposed a complete restatement of Section D of Part I of the Guidelines, the section that details the "comparability factors." But the revision, in line with the first major issue in the restructuring report and Chapter IX, identified two "key aspects" of such an analysis: (1) "to identify the commercial or financial relations between the associated enterprises and the conditions attaching to those relations in order that the controlled transaction is *accurately delineated*"; and (2) "to compare the conditions of the controlled transactions with the conditions of comparable transactions between independent enterprises."[127] By making the "delineation" two-step and emphasizing the role of the second, the Discussion Draft undermines the degeneration of the entire comparability analysis into an examination of "contractual terms": the terms must have standing as "comparable" to some uncontrolled group situation. And, as Chapter IX provides, if no *actual* external comparable is identifiable, the conformity must be to a *hypothetical* conception of what are or would be market terms.

The 2014 recharacterization draft also strengthened, to a considerable extent, language authorizing or directing tax administrations to displace or override the contractual terms, where "the facts and circumstances surrounding how those enterprises interact with one another in their economic and commercial context" warrant that "written contractual terms" be "clarified, or supplemented" by "the actual commercial or financial relations"; where the terms were not "reflected in the actual conduct of the parties," or did "not reflect a complete picture of the transactions" or had "been incorrectly characterised or labelled by the taxpayer," or were "a sham"; or where

126 *See* Langbein & Fuss*, supra* note 7, at 371–73.
127 *2014 Recharacterisation Discussion Draft*, *supra* note 119, ¶ 1.

the "actual outcome of commercial or financial relations may not have been identified as a transaction by the taxpayer, but nevertheless may result in a transfer of value."[128] In any of such cases, the terms of the transactions "would need to be deduced from the conduct of the parties."[129]

The second manner in which the Discussion Draft limited "contractual terms" concerned its provisions governing "risk." The Draft imported the two-part definition of Chapter IX of "control of risk." In the 2008/2010 business restructuring reports, the OECD had elaborated notions of "risk" and "control of risk": the "capacity to make decisions to take on the risk (decision to put the capital at risk); decisions on whether and how to manage the risk"; and the anticipated "financial capacity to bear the full consequences of the risk." [130]

The third manner in which the Discussion Draft would have tightened the transfer pricing rules was its provisions on "non-recognition" of intercorporate transactions.[131] Nonrecognition 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."[132] 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.[133] 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

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128 ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PUBLIC DISCUSSION DRAFT: BEPS ACTIONS 8, 9 AND 10: DISCUSSION DRAFT ON REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERIZATION, AND SPECIAL MEASURES), ¶¶ 2–5, 7, 44 (Dec. 16, 2014–Feb. 6, 2015) [hereinafter *2014 Recharacterisation Discussion Draft*].

129 *Id.* ¶ 7. The Discussion Draft listed the old "comparability factors," but various called them "economically relevant characteristics," as well as "comparability factors"; *see* Langbein & Fuss, *supra* note 7, at 372–73.

130 ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, ¶¶ 9.20, 9.32 (July 22, 2010).

131 Langbein & Fuss*, supra* note 7, at 373.

132 *2014 Recharacterisation Discussion Draft, supra* note 128, ¶ 88.

133 *Id.* ¶ 89.

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."[134] These provisions substantially reflected the fourth Issues Note of the 2008 Discussion Draft on restructurings,[135] provisions which were dropped in the final version incorporated as Chapter IX.[136]

The 2014 intangibles deliverable suggested two major inroads on the "contractual terms" regime, and its significant component, the "developer/assister" principle.[137] The first was clearly adumbrated by the 2012 intangibles discussion draft.[138] The second was not adumbrated, but was strongly suggested by the language of Actions 8 and 10 themselves. The second point was expressed only obliquely and at scattered points throughout the deliverable.

The deliverable set forth a proposed restatement of Chapter VI of the Guidelines concerning intangibles in its entirety. The deliverable began with a relatively broad identification of what constitutes "intangibles," which the deliverable defines 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."[139] 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 be susceptible of being "owned or controlled," and implicitly subject to "use or transfer," it rejects any

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[134] *Id.* ¶ 93.

[135] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS: DISCUSSION DRAFT FOR PUBLIC COMMENT, ¶¶ 194–221 (Sept. 19, 2008-Feb. 19, 2009) [hereinafter *2008 Discussion Draft on Restructurings*].

[136] *See* Langbein & Fuss, *supra* note 7, at 350–61.

[137] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, GUIDANCE ON TRANSFER PRICING ASPECTS OF INTANGIBLES ACTION 8: 2014 DELIVERABLE (2014) [hereinafter *2014 Action 8 Deliverable*].

[138] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, 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).

[139] *2014 Action 8 Deliverable*, *supra* note 137, ¶ 6.06.

requirement that the "something" be separately transferable, thus including items that may be transferable "only in combination with other business assets."[140] The deliverable specifically rejects any notion that "market conditions" constitute any kind of intangible.[141] The report stresses that the process of identifying an intangible is distinct from the process of determining a price for its transfer and emphasizes that intangibles must be identified "with specificity."[142] The deliverable thus, while accepting a broad definition, does not equate "intangibles" with anything so broad as the "profit potential" suggested by the second Issues Note of the 2008 restructuring Discussion Draft.[143] Correspondingly, the deliverable conceives a definition of "income from intangibles" narrower than the broader meaning discussed in Part I, and surely narrower than the conception of "intangible income" defined in the GILTI provisions.

The key device by which the deliverable proposes to align allocations with "value creation" involves a distinction between two categories of "transactions": transactions "involving the development, enhancement, maintenance, protection and exploitation of intangibles," (DEMPE transactions), on the one hand, and "transactions involving the use or transfer of intangibles," on the other.[144] Both categories are of intercompany "transactions." The second category is further subdivided into two categories: transactions "involving transfers of intangibles or rights in intangibles"[145] and transactions "involving the use of intangibles in connection with sales of goods or performance of services (embedded intangibles transactions)."[146]

It is by means of the first category–DEMPE transactions–that the deliverable diminishes the significance of the criterion of "legal ownership" of the intangible, as well as virtually repudiating the "developer/assister" conception. In this regard, the BEPS initiative picks up where the truncated intangibles project left off. The 2014 deliverable says that "the determination of the entity or entities within an MNE group which are ultimately entitled to share in the

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140 *Id.* ¶¶ 6.6–6.9.

141 *Id.* ¶¶ 6.9, 6.30.

142 *Id.* ¶¶ 6.10, 6.12.

143 *2008 Discussion Draft on Restructurings*, *supra* note 135, ¶ 92.

144 *2014 Action 8 Deliverable*, *supra* note 137, ¶¶ 6.72, 6.84.

145 *Id.* ¶ 6.85.

146 *Id.* ¶ 6.101.

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."[147]

The deliverable lists reasons why the determination of what contributions have been made and how to compensate them may be "highly challenging"[148] 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 prior OECD Guidelines or the United States regulations: "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 their relevant contributions of functions, assets, risks and other factors contributing to the creation of value"; and "where possible, determining arm's length prices for these transactions consistent with each party's contributions of functions performed, assets used, and risks assumed."[149]

The 2014 deliverable also attaches considerable significance to what it defines as the "6.56 functions"; certain "important functions will have special significance."[150] These include "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"; or "important decisions regarding defense 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."[151] The report suggests special

[147] *Id.* ¶ 6.32 (footnote omitted).
[148] *Id.* ¶ 6.33.
[149] *Id.* ¶ 6.34.
[150] *Id.* ¶ 6.56.
[151] *Id.*

attention be paid to the methods employed in compensating such significant functions.[152]

> 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 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.[153]

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. Thus, it suggests that 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)";[154] 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"; that "[t]he 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," that "[t]he transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions";[155] that "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," and

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[152] *Id.* ¶¶ 6.56–6.57

[153] *Id.* ¶ 6.56.

[154] *Id.* ¶¶ 6.108–6.109 (emphasis added).

[155] *Id.* ¶ 6.130.

that "[o]*ne sided methods, including the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles.*"[156]

The 2014 intangibles deliverable at the same time suggested a greater role for the profit split method. It did so in a bracketed portion of the report—meaning it was subject to further consideration, particularly in connection with later discussion drafts on Actions 9 and 10—which covered the use of profit split methods both in connection with transfers and licenses of intangible property by one group member to another,[157] 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,[158] 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.

C. The Final Reports.

The most significant changes in the Final Reports concern the provisions of the Guidelines concerning the role of "risk" in the "delineation" of the transactions as to which a transfer price is to be assigned or determined. The December 2014 Discussion Draft had demoted the role of "contractual terms" in two principal ways. First, it re-emphasized that a "comparability analysis" was a two-step process, and that, while "contractual terms" and other factors played a role in the first step, there was a second step, which examined the "economic substance" of the terms, and demanded that they comport with an objective standard of "arm's length" terms (which might be conceived or developed in the abstract, rather than necessarily derived from an identified "comparable").[159] Second, it emphasized "control of risk" as a critical element of such a standard, incorporated an analogue of "people functions," and an examination of "financial capacity" to assume a risk into determining the place or particular enterprise where risk could be determined to be "controlled."[160]

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156 *Id.* ¶ 6.138 (emphasis added).
157 *Id.* ¶¶ 6.145–6.149.
158 *Id.* ¶ 6.109.
159 *Id.*
160 *Id.*

The Final Reports largely reverse and limit this demotion by setting forth a six-step process for analyzing risk in a transfer pricing context. The six-step process so defined largely restores a central role to contractual terms. The first step is to "[i]dentify economically significant risks with specificity."[161] The second is to determine how these risks are "contractually assumed" by the associated enterprises "under the terms of the transaction"[162]—and this is the key step in restoring the critical role to "contractual terms." The third is a functional analysis of how the parties "operat[e] in relation to assumption and management" of these risks, "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."[163] The fourth step is to determine "whether the contractual assumption of risk is consistent with the conduct of associated enterprises and other facts of the case"[164]—a considerably narrower expression of the circumstances in which contractual terms may be disregarded or modified than that expressed in the December 2014 Discussion Draft.

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. The sixth step is the actual pricing, taking into account risk assumptions "as appropriately allocated," and "appropriately compensating risk management functions."[165]

As to the fifth step, the Final Reports note simply that if it is established by the fourth step that the party, which 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."[166] But even in such circumstances, it is very cloudy in its description of what kind of tax ad-

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161 *2017 Transfer Pricing Guidelines*, *supra* note 14, ¶ 1.60.
162 *Id.*
163 *Id.*
164 *Id.*
165 *Id.*
166 *Id.* ¶ 1.98.

ministration responses are in order. The Reports conclude, 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," 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 nonrecognition.[167]

These rules by their terms restore considerable scope to contractual allocations, as they are a starting point under step two; but in practice, they are likely to accord even greater scope to those allocations. There are distinct uncertainties in the meanings of both "financial capacity" to assume risks and in identifying the party in a group which can manage or control risk. This means that in the third and fourth step there are likely to be serious obstacles in most situations to ever determining a "risk allocation" that is ultimately too different from what the "contractual" allocations would be. The contractual allocations are likely to withstand any serious attack in many if not most circumstances.

In contrast to the fate of innovations in the risk/recharacterization Discussion Draft, the basic incremental advances of the intangibles deliverable – the analysis of DEMPE transactions, overriding "developer/assister" and intangibles-ownership notions, and the suggestions that profit split approaches rather than "one-sided" methods may be superior devices in the context of intangibles – survived review and are a prominent part of the final version of Chapter VI of the revised 2017 Guidelines. But the changes wrought by the Final Report with respect to "risks" influenced the provisions of the Final Reports to be included in Chapter VI, almost always in the direction of revivifying the role of "contractual terms" and diluting the force of the innovations suggested by the deliverable.

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[167] *Id.* ¶ 1.99.

The 2014 deliverable set forth a "framework for analysing transactions involving intangibles" at the outset of its section on DEMPE, including a six-step process derived from 2012 Discussion Draft on intangibles. The first step involved "identifying the legal owner 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"; the second "identifying the parties performing functions (including specifically the important functions [noted above]), using assets, and assuming risks related to developing, enhancing, maintaining and protecting, and exploiting the intangibles by means of the functional analysis."[168] The Final Reports changed the language describing these two steps 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" and to "[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."[169] Both sets of changes elevated the role of contractual assignments, including but not limited to, incorporating the six-step risk-analysis framework, which itself emphasized the role of contract terms.

The deliverable had stated that "[w]hen no written terms exist, where the contractual terms are ambiguous or incomplete, or where the factual substance of the transaction as reflected in the conduct of the parties is inconsistent with the written contracts, the terms of a transaction must be inferred from the conduct of the parties *and the economic principles that generally govern relationships between independent enterprises*,"[170] reflecting the idea of the restructuring project of a conception of market or arm's length terms dependent not on actual comparables, but on general concepts. The corresponding provision in the Final Reports states that in these circumstances,

168 *2014 Action 8 Deliverable*, *supra* note 137, ¶ 6.34.
169 *2017 Transfer Pricing Guidelines*, *supra* note 14, ¶ 6.34.
170 *2014 Action 8 Deliverable*, *supra* note 137, ¶ 6.36 (emphasis added).

"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)," omitting any such conception of a deduction of an "arm's length" division not determined by "comparables."[171]

The Final Reports made extensive changes and additions to the provisions governing the internal allocations with respect to the DEMPE of intangibles and 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. These generally confine the funding party to a return on the "funding and risk-taking,"[172] narrowing the idea of dispersed "intangibles related returns," and enhancing the role of allocations to a "central" party. 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 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."[173]

Similar changes reflecting incorporation of the "control of risk" ideas, which give greater emphasis to contractual allocations, appear throughout the Final Reports.[174] Perhaps the most significant change the Final Reports make to the earlier deliverable concerns the "central" functions identified in paragraph 6.56[175] and the provisions concerning allocations to a "legal owner" with respect to those functions. The 2014 deliverable provided that "[b]ecause 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

171 *2017 Transfer Pricing Guidelines*, *supra* note 14, ¶ 6.36.
172 *Id.* ¶¶ 6.60–6.64.
173 *Id.* ¶ 6.69; *see id.* ¶ 6.70.
174 *See id.* ¶¶ 6.40, 6.42, 6.49, 6.77, 6.91, 6.97, 6.104, 6.114, 6.128.
175 *Id.* ¶ 6.56.

methods and valuation techniques, to appropriately reward the performance of those important functions " It said furthermore that "*[w]here 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*."[176]

The Final Reports rendered what was said to have been "doubtful" to merely something that should be "carefully considered," saying that "[w]*here 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 actually performs, the assets it actually uses and the risks it actually assumes under the guidance in Section D.1.2 of Chapter I."[177]

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."[178]

V. GILTI, FDII, AND BEAT

A. GILTI.

Section 951A(a) provides that any person who is a United States shareholder ("USS") of any controlled foreign corporation ("CFC") for any taxable year of the USS must include in gross income the shareholder's global intangible low-taxed income ("GILTI") for the taxable year.[179] Section 951A(b)(1) defines GILTI as the excess of

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176 *2014 Action 8 Deliverable*, *supra* note 137, ¶ 6.57 (emphasis added).

177 *2017 Transfer Pricing Guidelines*, *supra* note 14, ¶ 6.57 (emphasis added).

178 *See*, *e.g.*, *id.* ¶¶ 6.145, 6.148–6.149.

179 I.R.C. § 951A(a) (2017); *see also supra* note 29 (discussing the meaning of the terms "United States shareholder" and "controlled foreign corporation").

the shareholder's "net CFC tested income" (NCTI) for the taxable year over its "net deemed tangible income return" ("NDTIR") for the taxable year.[180] Section 951A(b)(2) defines NDTIR as 10 percent of the aggregate of the shareholder's pro rata share of the "qualified business asset investment" ("QBAI") of each CFC with respect to which the shareholder is a USS for the taxable year over the amount of certain interest expense.[181] The amount of that offset is the amount of interest taken into account in determining the shareholder's NCTI to the extent the interest income attributable to the expense is not taken into account in determining the shareholder's NCTI.

Section 951A(c) defines NCTI as the excess of the aggregate of the shareholder's pro rata share of the "tested income" of each CFC with respect to which the shareholder is a USS for the taxable year of the USS over the aggregate of the shareholder's pro rata share of the "tested loss" of each such CFC.[182] Section 951A(c)(2) defines term ''tested income'' as the excess of the gross income of the corporation determined without regard to certain amounts, principally those constituting or associated with deemed or actual distributions of "subpart F income" from the CFCs over the deductions properly allocable to that gross income.[183] The term ''tested loss'' means the excess of any such deductions over the gross income included in determining tested income.

Section 951A(d)(1) defines QBAI, with respect to each CFC, as "the average of the corporation's aggregate adjusted bases as of the close of each quarter of the taxable year in specified tangible property used in a trade or business of the corporation, and of a type with respect to which a deduction for depreciation is allowable . . . ."[184] Section 951A(d)(2) defines ''specified tangible property'' as any tangible property used in the production of tested income.[185] Section 951A(d)(2)(B) provides that if "property used both in the production of tested income and income which is not tested income," the property is treated as specified tangible property in the same proportion

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180 I.R.C. § 951A(b)(1) (2017).
181 I.R.C. § 951A(b)(2) (2017).
182 I.R.C. § 951A(c) (2017).
183 I.R.C. § 951A(c)(2) (2017).
184 I.R.C. § 951A(d)(1) (2017).
185 I.R.C. § 951A(d)(2) (2017).

that the gross income included in determining tested income produced with respect to the property bears to the total gross income produced with respect to the property.[186] Section 951A(d)(3) provides that the adjusted basis in any property is determined by using the alternative depreciation system under section 168(g) and by allocating the depreciation deduction with respect to the property ratably to each day during the period in the taxable year to which the depreciation relates.[187] Section 951A(d)(3) sets forth rules for determining the treatment for these purposes of tangible property held by a CFC through a partnership.[188]

Section 951A(e)(1) provides rules for determining pro rata shares for these purposes.[189] Section 951A(e)(2) provides that a person is treated as a USS of a CFC "for any taxable year of the person only if the person owns (within the meaning of section 958(a)) stock in the foreign corporation on the last day in the taxable year of the foreign corporation on which the foreign corporation is a controlled foreign corporation."[190] Section 951A(e)(3) provides that "foreign corporation is treated as a CFC for any taxable year if the foreign corporation is a CFC at any time during the taxable year."[191]

Section 951A(f)(1)(A) provides that any amount included as GILTI is treated as an amount included under subpart F for purposes of specified provisions of the Code, "income under subsection (a) shall be treated in the same manner as an amount included under section 951(a)(1)(A) for purposes of applying sections" certain enumerated provisions of the Code.[192] Section 951A(f)(2) provides for the allocation of the GILTI included by a shareholder among the CFCs of which the shareholder is a USS, primarily on the basis of the ratio of the shareholder's share of the tested income of that CFC to the aggregate amount of tested income of all the CFCs of which the shareholder is a USS.[193]

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186 I.R.C. § 951A(d)(2)(B) (2017).
187 I.R.C. § 951A(d)(3) (2017).
188 *Id.*
189 I.R.C. § 951A(e)(1) (2017).
190 I.R.C. § 951A(e)(2) (2017).
191 I.R.C. § 951A(e)(3) (2017).
192 I.R.C. § 951A(f)(1)(A) (2017).
193 I.R.C. § 951A(f)(2) (2017).

It is best before going further to illustrate this provision with a simple example, which we may use as a building block as the discussion gets more complicated.

> **EXAMPLE 1.** Assume USP is a United States corporation which owns all of the shares of two foreign corporations, CFC1, incorporated in Country M, and CFC2, incorporated in Country N. Assume all three corporations have taxable years which are the calendar year. In 2019, CFC1 has gross income included in computing "tested income" of 300*u*, with which are associated deductions of 180*u*, and tangible property used in producing this income and subject to an allowance for depreciation of 800*u*. In 2019, CFC2 has gross income included in computing "tested income" of 600*u*, with which are associated deductions of 360*u*, and tangible property used in producing this income and subject to an allowance for depreciation of 400*u*.
>
> The "tested income" of CFC1 is 120u: 300u, reduced by 180u. The "tested income" of CFC1 is 240u: 600u, reduced by 360u. The NCTI is the sum of these two amounts, or 360u.
>
> USP's share of the QBAI of CFC1 is 800u. USP's share of the QBAI of CFC2 is 400u. The aggregate of the two is 1200u, and the NDTIR is ten per cent of that, or 120u.
>
> USP, accordingly, has GILTI for the year of 240u, 360u reduced by 120u. This is included in its income as a Subpart F deemed distribution.

At the same time it enacted section 951A, Congress enacted new section 960(d), which provides a foreign tax credit with respect to any inclusion mandated by section 951A.[194] Section 960(d)(1) provides that any domestic corporation which has an inclusion of GILTI is deemed to have paid foreign income taxes equal to 80 percent of

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[194] I.R.C. § 960(d) (2017).

the product of the domestic corporation's inclusion percentage, multiplied by the aggregate tested foreign income taxes paid or accrued by controlled foreign corporations.[195] Section 960(d)(2) provides that the inclusion percentage is the ratio of the corporation's GILTI to the aggregate of the tested income over the tested losses of all the CFCs as to which the corporation is a USS.[196] Section 960(d)(3) defines the "tested foreign income taxes" as the foreign income taxes paid or accrued by the CFCs that are "properly attributable" to the tested income of such foreign corporation taken into account by such domestic corporation under section 951A.[197]

The TCJA amended section 904 to provide a separate "basket" for GILTI-related foreign tax credits and amended section 904(c) to disallow any carryover or carryback of GILTI-related foreign income tax credits.[198]

> **EXAMPLE 2.** In our example above (Example 1), assume that Country M has an income tax with a tax rate of 30%, and Country N has an income tax with a tax rate of 20%. Assume the United States tax rate is 21%. Assume that the tax base in both Country M and Country N is the same as the "tested income" of CFC1 and CFC2, respectively. CFC1 will have tested foreign income taxes subject to the credit of 36*u* (30% of 120*u*); CFC2 will have foreign income taxes related to GILTI of 48*u* (20% of 240*u*). The inclusion percentage for CFC1 is the GILTI (240*u*) divided by the aggregate of the tested income of the corporations (360*u*), or 2/3.
>
> USP will include income a total of 296*u*, the sum of (x) GILTI of 240*u;* and (y) taxes deemed paid of 56*u* (2/3 of the total foreign taxes of 84*u*).[199] It will have

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[195] I.R.C. § 960(d)(1) (2017).
[196] I.R.C. § 960(d)(2) (2017).
[197] I.R.C. § 960(d)(3) (2017).
[198] I.R.C. § 904(2017).
[199] I.R.C. § 904(2017). Under section 902 of the Code, as in effect before TCJA, any United States person is allowed a foreign tax credit for income taxes "deemed paid" by any foreign corporation of which the person owns 10 percent

> creditable foreign taxes of 44.8*u* (80 per cent of 56*u*). USP's United States tax attributable to the GILTI inclusion is 50 per cent of 21 per cent of 296*u*, or 31.08*u*. USP may claim a foreign tax credit of 44.8*u*, so that the inclusion in GILTI does not increase USP's United States tax liability. The excess of the creditable taxes over the credit allowed (13.72*u*, 44.8*u* reduced by 31.08*u*) creates neither a tax carryback nor a carryforward. Nor, because of the separate "basket" for GILTI income, may it be used against any tax on current (same-year) income from foreign branches, or foreign passive income, or any other foreign income.

This example assumes relatively high foreign tax rates, with the result that the foreign tax credit eliminates any United States tax. Let us do a calculation assuming lower tax rates, including the assumption that CFC2 is a "cash box" in a tax haven with low rates, to which income has been shifted.

> **EXAMPLE 3.** The net effect of the GILTI inclusion, with the section 250 deductions, can again be illustrated by reference to our extremely simple example set forth above. In Example 2, we assumed Countries M and N were relatively "high-tax" foreign states with flat rates of 30% and 20%. Let us make those calculations assuming the foreign states have relatively low flat rates: assume Country M is a developed country, with "real" participation in the transactions with USP, but that it has followed the TCJA rate reductions by enacting a 15% flat rate. Assume Country N is a "base country" or "tax haven"

or more of the corporation if and when amounts are actually or constructively deemed distributed by the foreign corporation. I.R.C. § 904 (2017).
Under section 78 of the Code, the amount of the taxes so deemed to be paid are also included in the income of the distributee. I.R.C. § 78 (2017). As amended by TCJA, section 78 provides for the inclusion of the foreign taxes deemed paid with respect to GILTI (under section 960(d)), determined without regard to the 80 per cent limitation, but with regard to the amount limited by the inclusion percentage. *Id.*; *see also* I.R.C. § 906(d) (2017).

with a flat rate of 5%. CFC1 incurs a tax to Country M of 18*u* (15% of 120*u*); CFC2 incurs a tax to Country N of 12*u* (5% of 240*u*). The total foreign tax is 30*u*; the creditable amount is 80% of 2/3 that (16*u*). USP incurs a United States tax of 15.08*u*. There are no "excess" credits.

B. FDII.

The TCJA also enacted a new section 250, providing for a special deduction for "foreign-derived intangible income" ("FDII") and GILTI, resulting in a special rate of tax on such income.[200] FDII is a concept parallel to GILTI, but included in the income of a domestic taxpayer that does foreign business other than in corporate form. Section 250(a)(1) provides for a deduction of 37.5 per cent of the FDII and 50 per cent of the sum of the GILTI and the amount included in income on account of any foreign taxes (such as withholding taxes) attributable to actual distributions of GILTI.[201] The deduction is limited to the total taxable income of the domestic corporation should the sum of the FDII and the distributed GILTI exceed the total taxable income. For taxable years beginning after December 31, 2025, the deduction for FDII is reduced to 21.875 per cent and to 37.5 per cent for actual GILTI distributions.[202]

Section 250(b) defines FDII as the amount which bears the same ratio to the "deemed intangible income" ("DII") as the foreign-derived deduction eligible income ("FDDEI") bears to the deduction eligible income ("DEI").[203]

DII is defined in a manner that parallels the definition of GILTI in section 951A(a). The DII is the excess of the DEI over the deemed tangible income return ("DTIR"): DEI parallels the term NCTI in section 951A; DTIR parallels the definition of NDTIR in section

200 I.R.C. § 250 (2017).

201 I.R.C. § 250(a)(1) (2017). Upon an actual distribution by a foreign corporation, the foreign country may impose a tax on the distributee with respect to the amount of the distribution. In such a case, the distributee, if eligible for foreign tax credits, may claim both a "deemed paid" credit for the amounts of tax imposed on the income of the foreign corporation on which the taxes were imposed, and a credit for taxes imposed directly upon the distributee with respect to the actual distribution.

202 I.R.C. § 250(a)(1)(A) (2017).

203 I.R.C. § 250(b) (2017).

951A(b). Thus, the DTIR is equal to 10 percent of the corporation's QBAI – same definition as in the GILTI provisions, substituting DEI for tested income. Paralleling, though not replicating exactly, the definition of tested income in section 951A(c), the DEI is the gross income of the corporation computed with exclusions for income from CFCs, including both regular Subpart F inclusions and inclusions with respect to GILTI, as well as financial services income and foreign branch income, reduced by allocable deductions. The exclusion of financial services income is significant, since foreign operation through branches rather than subsidiaries is most common in the banking and financial services sectors. The exclusion is *unfavorable* to financial sector taxpayers, because treatment as intangible income with respect to branches qualifies the taxpayer for a *deduction* from taxable income, not an inclusion as in the case of GILTI.

The FDDEI is DEI-derived in connection with property sold by the taxpayer to any person who is not a United States person, and which the taxpayer establishes to the satisfaction of the Secretary is for a foreign use, or for services provided by the taxpayer which the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States. The statute defines foreign use as "any use, consumption, or disposition which is not within the United States." It sets forth rules for determining when property or services are for foreign use, including rules for property dispositions or performance of services for unrelated and related intermediaries.

This parallel belies, or obscures, critical differences between the GILTI and FDII regimes, and in so doing creates some confusion about the net revenue consequences of this "intangible income" system in its entirety. The most serious consequences flow from the fact that, while the GILTI provisions limit the foreign tax credits it generates, the FDII provisions do not affect the foreign tax credits claimable against the income that qualifies for the deduction.

The revenue consequence of the entire "intangible property" scheme can be apprehended only by looking at what it does with respect to an entity operating through foreign branches. To do this, we can use the same numbers used in our examples but assume that CFC1 and CFC2 are not separately incorporated entities, but rather branches of USP.

> **EXAMPLE 4.** In this scenario, absent the FDII provisions, USP would have income attributable to the branches of 360*u*. Using the foreign tax rates in Example 2 (30% and 20%), USP would incur 36*u* in Country M tax, and 48*u* in Country N tax, generating foreign tax credits of 84*u*. The inclusion of 360*u*, assumed entirely to be FDII, would generate a deduction of 135*u* at 37.5%. Thus, the net inclusion would be 225*u*, subject to tax at 21%, generating a pre-credit tax of 47.25*u*. The foreign tax credits would eliminate any U.S. tax, but would leave the taxpayer with excess credits of 36.75*u*. There would be some difficulty using these credits, because the income is foreign branch income, which after TCJA is placed in a separate "basket." But they could be used against other low-taxed foreign branch income (giving the taxpayer an incentive to allocate "intangible" income connected with other foreign operations to itself rather than any foreign subsidiaries). The excess credits could also be carried forward or carried back.
>
> Using the foreign tax rates in Example 3 (15% and 5%), USP would incur 18*u* in Country M tax, and 12*u* in Country N tax, generating foreign tax credits of 30*u*. Thus, USP would have United States tax liability of 17.25*u*, and 0 foreign tax credit available for carryback or carryover.

The net consequence of the overall scheme is appreciated by comparing what happens to USP (in consequence of the combined GILTI/FDII regime) as between operating through foreign branches or foreign subsidiaries. Using the Example 2 (relatively high) rates, the United States tax after the foreign tax credit is zero whether the parent operates through branches or subsidiaries. This is true even though, on account of "territoriality" and the reduced United States rate, the pre-credit United States tax is much higher where the parent operates through a foreign branch. But in the branch case, in addition to paying no tax, the parent has potentially valuable credits 36.75*u*. Using the lower Example 3 rates, by contrast, the parent operating through branches pays a slightly higher after-credit United States tax (17.25*u* vs. 15.08*u*).

These admittedly oversimplified numbers suggest an opportunity for tax planning; companies will be better operating through branches to the extent their foreign operations are more heavily taxed and through subsidiaries where their operations are more lightly taxed. This is neither new nor surprising, at least at first blush: under the pre-TCJA non-territorial system with its "overall" foreign tax credit, branches were preferable for operations subject to higher foreign taxes and subsidiaries in lower-taxed environments. What may be surprising is that, with the addition of GILTI/FDII, the post-TCJA "territorial" system retains (or reintroduces) this feature: under territoriality, with the supposed exemption of foreign income, the level of taxation of foreign operations should not affect the choice of form for the operations. But the partial inclusion of intangible income limits this feature. At the same time, however, the overall operation of the FDII/GILTI system, though on its surface it appears to *raise* revenue and *limit* tax avoidance opportunities may do just the opposite – it may *lose* revenue and create new *planning* and *avoidance* horizons.

This does not mean, at least in terms of first order effects, that the overall scheme of the TCJA is a net revenue loser. The amount of income that will be subject to the GILTI provisions presumably greatly exceeds that that will be subject to the FDII provisions. But first order effects are not static. The overall set of provisions create planning opportunities, which may make it advisable for firms to convert operations conducted through foreign subsidiaries to branch operations, reducing the GILTI inclusions and taking advantage of the tax *reduction* effected by the FDII rules. And, given the existing United States "check-the-box" choice of entity regulations,[204] switching between branch and subsidiary operations may present fewer nontax obstacles than one might at first assume.

C. BEAT.

The TCJA[205] also enacted a new minimum-type tax, dubbed the "base erosion anti-abuse" tax (sometimes the "BEAT"). As the

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[204] *See* 26 C.F.R. § 301.7701–1(a)(1); 26 C.F.R. § 301.7701-3.

[205] Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 § 12001 (2017).

GILTI/FDII aimed at profit shifting in the "outbound" situation—the foreign activities of United States corporations—the BEAT aimed at low-taxed income in the "inbound" situation—the United States activities of foreign-based taxpayers. The BEAT is structured in a manner that parallels the alternative minimum tax ("AMT"), in effect after 1985 until it was repealed by the TCJA. The AMT proceeded by recomputing taxable income by adding back in certain tax "preferences" and "adjustments" and then proceeded to apply a rate lower than the "regular" rate to the enhanced amount of taxable income so computed. The resulting tax was then compared to the "regular" rate, and the higher rate is imposed. The BEAT proceeds by recomputing taxable income not by folding preferences or adjustments back in, but by disallowing deductions for certain payments to related foreign parties. A lower than normal rate is then applied to the enhanced, recomputed income figure, compared to the tax resulting from the higher rate but diminished base, and the higher rate is imposed.

The add-on tax equals the "base erosion minimum tax amount" ("BEMTA") of each "applicable taxpayer."[206] The BEMTA is the excess of 10 percent of the modified taxable income ("MTI") of the taxpayer over the regular tax liability ("RTL").[207] The offset for the RTL is itself reduced by an amount attributable to credits claimable against RTL. The amount of the reduction is complex, but tangential to this discussion. The MTI is the taxable income computed without regard to any "base erosion tax benefit" ("BETB") with respect to any base erosion payment (BEP), or the base erosion percentage of

[206] I.R.C. § 59A(a) (2017).

[207] I.R.C. § 59A(b)(1)(A) (2017). For taxable years beginning in calendar year 2018, the percentage is 5 percent. For any taxpayer that is a member of an affiliated group which includes a bank as defined in section 581 or a securities dealer registered under the Exchange Act, the percentages applied to MTI in computing BEMTA are 6 percent for taxable years beginning in 2018, and 11 percent for years beginning between January 1, 2019, and December 31, 2025. I.R.C. § 59A(b)(3)(A)-(B) (2017). For taxable years beginning after that, the percentages are 12.5 percent for taxpayers which are not members of an affiliated group which includes a bank or securities dealer, and 13.5 percent for taxpayers who are member of an affiliated group which does include either of those entities. I.R.C. § 59A(b)(2)(A) (2017).

any net operating loss deduction allowed under section 172 for the taxable year.[208]

There are four categories of "base erosion payments."[209] The first includes any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable.[210] The second includes any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer in connection with the acquisition by the taxpayer from such person of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation).[211] The third includes any premium or other consideration paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer for any reinsurance payments which are taken into account under sections 803(a)(1)(B) or 832(b)(4)(A).[212] The fourth includes certain payments to "expatriated entities" which result in a reduction of the gross receipts of the taxpayer.[213] These are payments to any surrogate foreign corporation which is a related party of the taxpayer, but only if the payee first became a surrogate foreign corporation after November 9, 2017, or any foreign person which is a member of the same expanded affiliated group as the surrogate foreign corporation.[214]

Payments are not included in the first category that meet the requirements for the use of the services cost method under the section 482 regulations,[215] determined without regard to the requirement

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208 I.R.C. § 59A(c)(1) (2017).

209 I.R.C. § 59A (d) (2017).

210 I.R.C. § 59A (d)(1) (2017).

211 I.R.C. § 59A (d)(2) (2017).

212 I.R.C. § 59A (d)(3) (2017).

213 I.R.C. § 59A (d)(4)(A) (2017).

214 I.R.C. § 59A (d)(4)(B)-(C) (2017).

215 The services cost method of the transfer pricing regulations essentially provides that, in the case of services performed by one corporate entity for or on behalf of an entity when the two are under common control (as defined in the section 482 regulations), an "arm's length" or appropriate charge for the services may be determined by an allocation of the cost of the services, without imputing any "profit element" to the provider of the services. The rules are intended generally to apply to the provision of routine services (such as stewardship of a subsidiary, or accounting services for an integrated enterprise), hence the normal re-

that the services do not contribute significantly to fundamental risks of business success or failure, if the amounts constitute the total services cost with no markup component. [216]

A BETB means:

- With respect to the first category of BEPs, any deduction allowed for any base erosion payment;[217]
- With respect to the second category, any deduction allowed for depreciation (or amortization in lieu of depreciation) with respect to the property acquired with the payment;[218]
- With respect to the third category, any reduction in premium income under section 803(a)(1)(B) and any deduction under section 832(b)(4)(A) from the amount of gross premiums written;[219]
- With respect to the fourth category, any reduction in gross receipts with respect to the payment in computing gross income.[220]

The base erosion percentage is determined by dividing the aggregate amount of base erosion tax benefits of the taxpayer for the taxable year by the sum of the aggregate amount of deductions allowable to the taxpayer for the year plus the base erosion tax benefits allowed with respect to the third and fourth categories of base erosion tax payments.[221] The denominator does not include deductions with respect to FDII or GILTI income, the deduction for dividends from 10 percent owned foreign corporations, or the deduction for net operating loss carrybacks or carryovers.[222]

An applicable taxpayer is a corporation other than RIC, REIT, or S corporation with average annual gross receipts for the three taxable years ending with the preceding taxable year of $500 million or more and for which the base erosion percentage is three percent or more.[223] Gross receipts of a foreign person include only those taken

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quirement that the services not contribute significantly to management of the fundamental risks of the business. The services cost method, and the prerequisites for its application, are set forth at Treas. Reg. § 1.482-9(b)(as amended in 2011).

216 I.R.C. § 59A(d)(5)(A)-(B) (2017).

217 I.R.C. § 59A (c)(2)(A)(i) (2017).

218 I.R.C. § 59A (c)(2)(A)(ii) (2017).

219 I.R.C. § 59A (c)(2)(A)(iii) (2017).

220 I.R.C. § 59A (c)(2)(A)(iv) (2017).

221 I.R.C. § 59A (c)(4)(A) (2017).

222 I.R.C. § 59A (c)(4)(B) (2017).

223 I.R.C. § 59A (e)(1) (2017).

into account in determining ECI.[224] All corporations that are aggregated as a controlled group are aggregated for purposes of determining gross receipts, except that the exception for foreign corporations in determining inclusion in a controlled group does not apply.[225] If the gross receipts of a United States person are aggregated with those of a foreign person, all of the gross receipts of the United States person are counted; the limitation to gross receipts giving rise to ECI does not apply with respect to the gross receipts of the United States person.[226]

A related party, for purposes of this provision, includes any 25 percent owner of the taxpayer, any person related under section 267(b) or 70(b)(1) to any such 25 percent owner, and any other party related to the taxpayer under the section 482 regulations.[227] A 25-percent owner is any person who owns 25 percent of more of either the total voting power of all classes of stock, or the total value of all classes of stock, applying section 318 attribution rules, except substituting 10 percent for fifty percent for purposes of section 318(a)(2)(C). Moreover, the entity attribution rules are not applied to consider a United States person as owning stock owned by a non-United States person.[228]

Section 59A(h) provides an exception for certain "qualified derivative payments" ("QDPs").[229] The exception is defined in a complex manner and again is tangential to our discussion here.

For taxable years beginning after 2025, the provision is applied by substituting 12.5 percent for 10 percent and by reducing the offset for the regular tax liability by the full amount of the allowable credits.

Although it does not, like the GILTI and FDII provisions, speak expressly in terms of "intangible income" or "intangibles," the BEAT provisions are focused on the avoidance of tax on cross-border income. This can be illustrated by an example parallel to the examples sketched above with respect to GILTI/FDII. Again, we can keep things simple.

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[224] I.R.C. § 59A (e)(2)(A) (2017).
[225] I.R.C. § 59A (e)(3) (2017).
[226] I.R.C. § 59A (e)(2)(A) (2017).
[227] I.R.C. § 59A (g)(1) (2017).
[228] I.R.C. § 59A (g)(2)-(3) (2017).
[229] I.R.C. § 59A (h)(1) (2017).

> **EXAMPLE 5.** Suppose foreign parent (FP) owns all the stock of a United States subsidiary (USS) and a subsidiary in a third country (BCS). Assume that the taxable income, apart from any base erosion payments, of USS is 300*u*, and that it has payments to BCS of 180*u*, all of which would qualify as base erosion payments. Suppose the payments are purported royalties with respect to intellectual property ownership of which has been vested by FP in BCS.
>
> The taxable income of USS is 120*u*, which is subject to a flat rate of 21%, so that the regular tax is 25.2*u*. The modified taxable income is computed without regard to the deduction for the payments to BCS, so it is 300*u*. The BEMTA is the excess of (x) 10% of 300*u* (30*u*), over (y) the regular tax (25.2*u*), or 4.8*u*.

VI. BEPS v. TCJA

As noted above, the peculiar feature of the enactment the GILTI, FDII, and BEAT provisions is their proximity in time to the promulgation of the final BEPS documents, while they represent initiatives quite different from those recommended (or mandated) by BEPS. Yet both initiatives appear to aim at the same difficulty—”base erosion” and “profit shifting”—with an emphasis on avoidance of tax on income that is in whatever sense “intangible.” This raises the question of comparing how and the extent to which each of the different initiatives would alter the tax consequences of a situation presenting the common difficulty each address. We can use the simple examples set forth in Part VI to do this.

At the outset, however, one must address a problem that grows out of the twin characteristics of BEPS, and indeed of the OECD Guidelines as a whole, of concomitant indefiniteness and extensiveness. We shall do this with some simplifying assumptions. We will focus on two and only two key changes BEPS made to the Guidelines. The first are the changes made to Chapter VI of the Guidelines concerning intangible property; in particular, the principle that all subsidiaries contributing to the development of an “intangible” are to be compensated currently for their contributions, notwithstanding the centralization of "ownership" of the intangible in any one or more separate subsidiaries. The second are the changes made to Chapter I of the Guidelines concerning control of risk, including the decision-making capacity concerning the assumption and management of risk, and the financial capacity to absorb risk. Both of these measures aim at diffusing returns throughout an affiliated group in response to an effort by the taxpayer group to centralize it, ordinarily in a low-tax jurisdiction.[230]

We can begin by using the example involving USP, CFC1, and CFC2 set forth above. Let us assume Country N is substantially a tax-haven "base country," and that CFC2's gross income is all "intangible" or "residual" income in the sense we have employed throughout. In order to assume that the BEPS Chapter VI principles would be meaningfully involved, we have to assume that some or much of this income is "intangible" in the sense that it is *imputable to actual intangible property*, in the manner set forth in the post-BEPS Guidelines. We also assume that the results stipulated in our example reflect a transfer pricing result based on rules/principles of the *pre-BEPS Guideline* or the United States regulations, and that, thus, they are dominated by "contractual allocation" and "developer/assister" or "intangible ownership" notions, which result in the allocation of the lion's share of income from the "intangible" to CFC2.

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[230] We will not concern ourselves here terribly with the choice of any transfer pricing "method." This is because we will assume that, once returns have been dispersed under either the intangibles rules or the risk rules, the allocation outcome will be the same whether we use a series of "one-sided" methods to determine a return to the variously dispersed "FAR" factors, on the one hand, or a profit split method the terms of which are based on how we have determined the FAR factors to be dispersed.
Additionally, it is important in making these comparisons not to become distracted by the question of tax rates, other than to recognize that we should limit any opportunity for undermining the effectiveness of base-protection rules by manipulation of rates. Some of the discussion in Part VI questions the effectiveness of the TCJA initiatives on the basis of the tax rates used (or deductions allowed as a method of adjusting rates). We should recognize, however, that the base-defining properties of the provisions may have merit which is disguised or counteracted by the actual provisions because of the low rates or high deductions employed.

Because we are going to be comparing the *overall*, *i.e.*, the "global" tax results under various regimes, we need to add some numerical assumptions to the above example, namely for USP's domestic income. Assume USP's domestic income is 300*u*. Assume throughout that the "tested" income is the same as taxable income in all countries and assume the tax rates set forth in Example 3—15% for CFC1 and 5% for CFC2. Assume a rate of 21% for the United States. On these assumptions, the USP group's total tax liability (worldwide), computed without regard to the GILTI inclusion, would be the sum of 63*u* (21% of 300*u*); 18*u* (15% of 120*u*); 12*u* (5% of 240*u*), or 93*u*. Its "global" effective tax rate would be 14.091% (93*u* as a percentage of its total global income of 660*u*). As indicated in Example 3, to this the GILTI provisions would add 15.08*u*, increasing the global tax liability to 108.38*u,* and the global effective rate to 16.42%.

Now, in order to analyze how BEPS principles would apply to this situation, we have to make some simplified assumptions. In the example as set forth above, CFC2 has "tested income" of 240*u*. Let us assume that we can determine that 160*u* of this income is attributable to an item of intangible property, *K*, and that another 60*u* is attributable to risks associated with the business that are "controlled," in the sense indicated by the BEPS Final Reports on Actions 8-10, in equal shares by USP and CFC1. Assume, too, that of the 160*u* of income attributable to item *K*; 40*u* would be absorbed by a payment to CFC1 for CFC1's contributions to the DEMPE of *K* and that 100*u* of the income would be absorbed by a payment to USP for USP's contributions to the DEMPE of *K*.

Thus, without GILTI in the United States or adoption of BEPS-type rules in any country, the "global" tax burden of the USP group is the sum of 63*u* in the United States (21% of 300);

We can reallocate the income of the group in accordance with these assumptions. There is no need to specify which of the transfer pricing "methods" we are using—profit split or a series of "one-sided" methods—because the outcome will be same regardless of method, because *the entire allocation is effected by our "reconstruction*," *or* "*delineation*" *to use the OECD's phrase, of the transaction*. Under this recalculation, CFC2's "tested" income is 20*u*—its pre-reallocation amount of 240*u*, reduced by the 160*u* allocated to USP and CFC1 on account of the intangible property, and the 60*u* reattributed on account of control of risk. This would generate a tax liability of 1*u* to CFC2.

CFC1's income would be increased by the allocation to Country M of 30*u* on account of the "control of risk" criterion of the BEPS Final Reports, and the allocation of 40*u* on account of the Chapter 6 intangible property rules of those Reports. Accordingly, CFC1's income increases from 120*u* to 190*u*. This generates a tax of 28.5*u* to CFC1.

USP's income increases by the allocation to the United States of 30*u* on account of "control of risk," and the allocation of 100*u* on account of the intangible property rules. This generates an additional tax of 27.3*u* to the United States on account of this "intangible" income.

On these assumptions, the USP group's total tax liability (worldwide) (assuming there is no GILTI tax) would be the sum of 90.3*u* (21% of 430*u*); 28.5*u* (15% of 190*u*); and 12*u* (5% of 240*u*), or 130.8*u*. Its "global" effective tax rate would be 19.818% (130.8*u* as a percentage of its total global income of 660*u*. The increase in the global tax burden on account of the BEPS adjustment is 37.8*u*.

We saw above (Example 3) that the *unilateral* United States adoption of GILTI/FDII would increase the global tax by 15.08*u* and the global tax rate by 2.429%—compared to these increases of 37.8*u* and 4.827%. Thus, *global* adoption of BEPS principles—even though those principles can be viewed from many perspectives as concessionary and limited—would increase the overall taxation of the group by many multiples of the increase effected by the unilateral United States measure, adopted without change in transfer pricing rules in the directions suggested (or mandated) by BEPS.

A similar demonstration can be made with respect to the BEAT. Let us assume, in a manner parallel to our assumptions in the GILTI examples, that a United States subsidiary ("USS") of foreign parent ("FP") is essentially in the same position as CFC1 in the GILTI examples and that between USS and FP is BCS, in a position like that of CFC2. Thus, we assume net income, before BEAT, of 240*u* in BCS, and 120*u* in USS. But assume that these results reflect a payment of an amount that would constitute a base erosion payment ("BEP") under the BEAT provisions, in the amount of 200*u*.

Ignoring the credit complexities of the BEAT computation, assume that the regular tax liability ("RTL") of USS is 21% of 120*u*, or 25.2*u*. The modified taxable income would add the 200*u* payment back into income, resulting in MTI of 320*u*. The BEMTA is the excess of 10% of the MTI over the RTL, or 32*u*, minus 25.2*u*, resulting in a BEMTA of 7.8*u*. Thus, the total tax on FP's foreign subsidiaries would be 32*u* plus 5% of 240*u* (12*u*), the tax imposed by Country N. If one made the adjustments under BEPS suggested above, one would add 70*u* to the income of USS; and 130*u* to the income of FP; and reduce BCS's income by 200*u*. This would result in an increase of USS' tax of 14.7*u*; and of FP's (at a 15% rate) of 19.5*u*. The total increase of 34.2*u* is more than four times the increase effected by the BEAT.

These observations are subject to numerous objections, but most can be addressed without impeachment of their central point. First, it may be that the comparison of unilateral adoption of the TCJA measures to *multilateral* adoption of BEPS is unfair. But under alternative comparisons, the result—that the TCJA measures are quite weak—is not altered. We might compare *unilateral* adoption of the TCJA measure to the unlikely prospect of unilateral adoption of BEPS principles (by Country M, in our example). But the numbers above give that comparison. In the GILTI case, BEPS increases the United States tax by 27.3*u*, compared to the increase of 15.08*u* under GILTI, a 180% difference; in the case of BEAT, the U.S. tax increase of 14.7*u* is more than twice the 7.2*u* increase effected by BEAT. In the more likely case of unilateral adoption of BEPS by the *foreign developed* authority without adoption by the United States, the comparison in terms of the increase in foreign taxes, versus the TCJA-mandated increases in United States tax (10.5*u* vs. 0.3*u* in the GILTI case; 19.5*u* vs. 7.2*u* in the BEAT case) still hold.[231]

In the latter case, too, some additional considerations must be noted concerning potential second order effects. If the foreign higher-tax country follows BEPS and thereby enhances its tax base, under the territorial system applicable to the corporate context, this

[231] Appendix II shows the changes in global tax liability in two alternative situations: (1) where the United States applies the GILTI tax, and Country M unilaterally applies BEPS; and (2) where the United States and Country *both* apply *both* the GILTI and BEAT provisions.

should be a matter of indifference to the United States, as in our example, the increase occurs because of an adjustment between CFC1 and CFC2. But the increase in foreign taxes will occur without an increase in income treated as a foreign source for United States purposes. This will mean that the increase in foreign taxes enhances the foreign taxes that may be claimed as credits against United States tax. But those taxes are not claimable with respect to income in foreign corporations that is not subject to the GILTI tax and are of limited value even if the income is subject to the GILTI provisions. But they are much more valuable if the income is earned through an unincorporated branch or other noncorporate entity and that income can be protected further through the FDII deduction. This creates incentives for the United States parent to liquidate its foreign entities and operate through branches, something which the United States "check-the-box" rules[232] greatly facilitate. If U.S.-based entities engage in such tax strategies, then the applicable transfer pricing regime could invite scrutiny under the AOA provisions, which are still "tougher" than the Transfer Pricing Guidelines, even as the latter have been amended by BEPS. Such inquiry could be complicated, since, as noted above, United States law has never taken the slightest cognizance of the OECD work on the AOA.

In addition, as noted above, if pursued on a widespread basis, this could result in revenue losses that might exceed the limited revenue gains from the application of the GILTI rules. In any event, these second order effects could magnify the extent to which the amount of "shifted" profits recaptured by BEPS exceed the amount recaptured by GILTI/FDII, if the latter system is taken as a whole.

A second objection to the example above, and the conclusions drawn from it, concerns whether it overestimates the magnitude of adjustment that might be mandated by BEPS, particularly with respect to the question of "control of risk." As the discussion above clarifies, there is considerable ambiguity in the BEPS report, as there has been throughout the Transfer Pricing Guidelines since the mid-1990s. Some of this ambiguity may be deliberate or necessary to secure multilateral agreement or consent to the terms of the Guidelines. The numbers given in the Example for the adjustments mandated by the BEPS innovations are of course assumed and arbitrary

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[232] *See* 26 C.F.R. § 301.7701–1(a)(1); 26 C.F.R. § 301.7701-3.

in the sense that there is no empirical basis for proving that the orders of magnitude they reflect are realistic or representative of amounts to which actual results would correspond. Nevertheless, they probably reflect, realistically, at least the outer or maximum limits of the results of applying BEPS. It is true that experience teaches us that such outer limits are likely to be considerably in excess of what tax authorities would be able to establish, or even to assert, in tax controversies with taxpayers. But the magnitude of the difference between what these assumptions yield as potential revenue harvests, and what is generated by GILTI/FDII/BEAT, means that even substantial overestimates of what the BEPS rules would warrant would not seriously undermine or overthrow the conclusion that BEPS compliance would have a significantly greater reach in subjecting "residual" or "intangible" profits to taxation by some nation where "value" is "created" than would the innovations of the TCJA.

A third objection to the example above and its implications concerns the relatively low tax rates (or high deductions mandated by section 250), or, in the case of GILTI and especially FDII, the availability and usefulness of foreign tax credits. The simple argument would be that the TCJA innovations would produce greater revenue, relative to the potential of the BEPS changes, if only the tax rate applicable to the inclusions mandated by GILTI/BEAT were higher, and approximated, or equaled, the rates applicable to corporate profits generally. In most discussions of transfer pricing, we tend to avoid discussions of tax rates and to treat the question as one of defining an appropriate base (or bases) of taxation. Again, however, the response concerns the magnitude of at least the potential difference between what BEPS yields and what the TCJA changes yield. Moreover, while to a serious extent the question is one of the design of measures to capture "intangible" income, a primary question here is the question of *actual United States policy* at the current time toward the taxation of such income. To the extent the latter is at issue, the actual rates, available deductions, and foreign tax credit rules are very much at issue and need to be analyzed as they were enacted, not as they might otherwise be designed.

The discussion above yields, in summation, a troubling conclusion about United States policy. The provisions adopted by the

TCJA—the GILTI, FDII, and BEAT provisions—bear the appearance of responses to the problem of "base erosion" and "profit shifting." They do this pursuant to international mandates—by the G-20 and the OECD—for member states (and others) to take measures to address these problems, identified by those bodies as important and international in scope. But they do not conform to the particular measures recommended and adopted by those bodies. And on closer inspection, they appear to be drastically weaker in their potential to combat the problem than the recommended measures—and this is in view of the fact, that, from many standpoints, the recommended measures are weaker than what many experts, and indeed many member states, sought to achieve.

This pattern recapitulates patterns observable in the past, notably in the revision of the United States regulations and the OECD Transfer Pricing Guidelines in the early and mid-1990s. There the Congress mandated a tightening of the rules, and rules were developed which originally appeared to affect the greater restrictiveness thus called for. The final rules, too, appeared to promise restriction, but beneath the surface created opportunities for tax avoidance significantly in excess of what had existed before, and the course of practice led to widespread exploitation by taxpayers of these opportunities. The international bodies, notably the OECD, exhibited awareness of and concern for these developments. The United States, however, not only exhibited little such concern, but actually appears to have promoted this form of tax leniency, increasingly diverging from OECD recommendations and an emerging international consensus outside the United States. This raises question of what real United States policy is and has been, and how it might be shaped in the future.

VII. UNITED STATES POLICY

The question of United States tax policy and international intangible income, currently and going forward, can be addressed only by understanding what has happened with respect to the taxation of such income since the revolutionary tax reform was enacted in 1986.

The two interludes during which transfer pricing rules evolved in the period since World War II—in the 1960s and 1985-95, both originated with congressional action in the United States. The reforms of the 1960s began in 1962 when the Kennedy Administration proposed "ending deferral"—that is, taxing currently the foreign earnings of all foreign subsidiaries of United States corporations on a "passthrough" basis.[233] The proposal garnered no meaningful support in Congress, but resulted in action with respect to two partial measures.[234] The first was the enactment of the Subpart F provisions, which "ended deferral," but only of the "base country" and passive income of subsidiaries to which income might be said to have been shifted. The second was the transfer pricing initiative. But that initiative was never written into statute. The House bill which became the Revenue Act of 1962[235] included a provision that would have mandated something very much akin to a formula apportionment regime for United States subsidiaries.[236] But the final enactment removed this in accordance with a promise from the Treasury Department that the matter could be handled administratively under section 482, without further statutory authority.[237]

In similar fashion in what became the Tax Reform Act of 1986,[238] the House Report expressed concern about the shortcomings of the then prevailing transfer pricing regime, but the Congress wrote into statute only a "super-royalty" provision paralleling an amendment to section 367 that had been enacted in 1984.[239] The House Report expressed considerable dissatisfaction with "the effectiveness of the 'arm's length' approach,"[240] and the Conference Report directed a Treasury study,[241] provided by the 1988 White Paper.[242] But the ultimate revisions to the regulations were such that their results involved no meaningful base broadening reform, but

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[233] Staff of the Comm. on Ways and Means, 87th Cong., Legislative History of The Revenue Act of 1962, at 142–47 (Comm. Print 1967).

[234] *See Myth, supra* note 32, at 644–45; Langbein & Fuss, *supra* note 7, at 312–13.

[235] Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962).

[236] H.R. REP. NO. 87-2508, at 18–19 (1962) (Conf. Rep.).

[237] *See* Michael L. Schler, *The Arm's Length Standard After Altera and BEPS*, 149 TAX NOTES 1149, 1150–51 (2015).

[238] Tax Reform Act of 1986, Pub. L. No. 99-514, 109 Stat. 2089 (1986).

[239] I.R.C. § 367(d) (2017).

[240] H.R. REP. NO. 99-426, at 423–25 (1986).

[241] H.R. REP. NO. 99-841, at II-638 (1986) (Conf. Rep.).

[242] U.S. TREASURY DEP'T, A STUDY OF INTERCOMPANY PRICING (1988).

rather an actual significant tax cut, amounting to a near exemption for the global "residual" income of multinationals. In this regard, transnational corporations enjoyed an effect of the 1986 Act that was denied any other sector of the economy. The 1986 Act effected significant reductions in maximum tax rates—from 50% to 28% for individuals, 46% to 34% for corporations. But the overall statute was supposed to be "revenue neutral"—the rate reductions were to be offset by measures which broadened the base of the tax. But for "global intangible" income—the transfer pricing "residual"—the net result was *both* a reduction of rates *and* a narrowing of the tax base.

Moreover, the 1986 Act rate reduction coupled with base broadening reform in the United States became an international model: most major foreign countries enacted parallel reductions in maximum corporate rates, a major feature of the "globalization" initiatives that ensued after the end of the so-called Cold War. When the United States-originated "contractual terms" pseudo-reform was embraced by the OECD, this phenomenon—of a major reduction in the tax burden of multinational corporations, with rate reductions coupled with heavily disguised base narrowing rules—became a worldwide occurrence.

Since the mid-1980s, there has been widespread interest in, and coverage of, transfer pricing matters in the United States in academic literature; in excellent periodical (daily, weekly, or monthly) professional services materials both covering tax matters or international tax matters generally, or even transfer pricing in particular;[243] and, to a lesser but still significant extent, in the daily general and financial press.[244] But for all that attention, focus on the pertinent issues narrowed after the finalization of the revision of the OECD Guidelines in 1995-96. As to academic literature, there came to be a fairly common scholarly view, perhaps not generally accepted but

[243] This coverage is provided by *Tax Notes*, *Tax Notes Today*, and *Tax Notes International*, all published by Tax Analysts, and by Bloomberg/BNA's *Daily Tax Report* and most especially its *Transfer Pricing Report*, the latter dedicated exclusively to transfer pricing matters.

[244] *See, e.g.*, Sam Schechner, Paul Hannon, & Richard Rubin, *Nations Seek to Split Taxes on Tech,* WALL ST. J., Feb. 15, 2018, at B10; *see also supra* note 9 and accompanying text and sources.

still widely held, that the arm's length method was flawed as a theoretical matter and should be discarded in favor of some form of formula apportionment.[245] But this literature came to have something of an unrealistic, howling-at-the-moon quality: it largely either ignored or offered no options with regard to the solid official and private opposition to any departure from the fundamental premises of existing practices. At the same time, it did not confront any details of the changes that had been made by the new Guidelines, of the new tensions and differences between the international and the United States rules, and of the manner in which the new rules were being implemented and the efforts of the OECD to accommodate some of the fundamental concerns implicated in the objections to "arm's length." In this regard, the academic literature may have partaken of the more general tendency in the period of at least legal academic literature to be increasingly unconcerned with matters of practice and application, as opposed to abstract and self-referential theory, a tendency often observed in academic literature concerning legal education as well as in the general press.

But even the professional periodical coverage of the matter in this period became quite oblivious of certain important matters, namely the manner in which practice under the new regulations and Guidelines was degenerating into wooden elevation of "contractual terms" analysis and of the complex efforts of the OECD to exert pressures to counter such developments. Moreover, at least some of the publications involved, many of which had historically been sympathetic to reform efforts, drifted to positions much more protective of corporate and taxpayer interests.[246] As suggested throughout, official activity in the area took little cognizance of the progressive aspects of the OECD's AOA and restructuring projects. And transfer pricing largely disappeared as a matter of interest to the daily financial or general press.

There was some change in this situation in the late part of the first decade of the new century and the early part of the second decade. This is the period that constituted the immediate prelude to the rise of international concern about profit shifting. Most important

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[245] *See*, *e.g.*, Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301 (1996).

[246] *See supra* note 243 (this was especially true of the Tax Analysts publications cited).

were articles in the general press detailing the widespread pattern of very light taxation imposed on some United States-based multinationals, primarily the largest and most important technology companies, although also including some retail firms (*e.g.*, Starbucks).[247] Advocacy favoring fractional apportionment became more frequent and intense. A former head of the United States advance pricing agreement program, who had long forcefully defended the "arm's length" system, switched sides and became a supporter of a formula system.[248] And the prestigious Brookings Institution, through a prestigious Hamilton Project which made generally progressive proposals concerning a wide range of economic matters, issued a recommendation for a "residual" formula apportionment system,[249] although the report roughly replicated a proposal detailed almost two decades earlier during the "transfer pricing wars."[250]

Even officially, there was some movement toward strengthening the taxation of the foreign income of United States-based multinationals. Legislation enacted in 2010 made complex reforms of the foreign tax credit system.[251] These reforms were regarded as changing the foreign tax credit from one which was "better than exemption," to one with some real teeth. Some suggested it was these reforms that provoked the international business community into much more serious advocacy of and lobbying for movement to the "territorial" system ultimately adopted by the TCJA.[252] In the later part of this period, prompted by both the academic literature and the

247 *See supra* note 9 and accompanying text.

248 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).

249 *Id.* Durst was the former director of the advanced pricing agreement program who had switched to advocating a formula apportionment system.

250 *See* Stanley I. Langbein, *A Modified Fractional Apportionment Proposal for Tax Transfer Pricing*, 54 TAX NOTES 719, 719 (1992); Avi-Yonah, Clausing & Durst *supra* note 248; *see* Langbein & Fuss, *supra* note 7, at 330 n.332.

251 The Education Jobs and Medicaid Assistance Act of 2010, Pub. L. No. 111-226, 124 Stat. 2389 (2010) (adding section 901(m), governing "covered asset acquisitions," and section 909, governing "foreign tax credit splitting events," both of which limited the benefits of "cross crediting" of foreign taxes); *see* STANLEY I. LANGBEIN, FEDERAL INCOME TAXATION OF BANKS AND FINANCIAL INSTITUTIONS ¶ 12.05[10] (2018).

252 *See* J. Clifton Fleming, Jr., Robert J. Peroni, & Stephen E. Shay, *Worse Than Exemption*, *59* EMORY L. J. 79 (2009-2010).

press reports, there were congressional hearings that became part of the initiatives that led to BEPS.[253]

Even in the face of these developments, however, there was little appetite for examining in detail the transfer pricing issue and particularly the details of the arm's length system as it had degenerated into the system dominated by "contractual terms." The academic literature on "stateless income" tended to focus on features of the *domestic* law of particular countries that facilitated subjecting entities organized in developed country jurisdictions to "global" taxation by tax haven jurisdictions—the so-called "double Irish" and "Dutch sandwich" structures. They did not highlight the role of the transfer pricing rules and "contractual terms" in creating "stateless income" even among entities organized under the normal corporate laws of the nations involved, without any special structures or other "harmful tax practices."[254] When the European Union took action against certain members for "subsidizing" companies with these practices, the focus was on particular laws or particular countries which could be characterized as "harmful"; there was a natural tendency to look away from rules that had been internationally agreed upon and for which there could thus be no basis for imputing blame to any particular member state.

By the middle of the century's second decade, however, most of the energy represented by these earlier efforts had dissipated, along with enthusiasm for serious changes in connection with BEPS. Serious consideration of these matters in the academic literature largely disappeared; indeed, what are perhaps the two most prominent academic publications devoted to tax matters have rarely published pieces tilting toward the anti-arm's length position, while more frequently highlighting pieces taking the opposite side.[255] Similarly, the periodical professional services have exhibited a steady drift toward taking the taxpayer/corporate side.[256] The courts, meanwhile, and particularly the Tax Court, have been stringently on the

[253] *See supra* note 11.

[254] Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2011); Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011); Edward D. Kleinbard, *Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011).

[255] This refers to the TAX LAW REVIEW and the VIRGINIA TAX REVIEW.

[256] *See supra* notes 243 and accompanying notes and sources.

taxpayers' side; the IRS has valiantly pursued a litigation strategy attempting some strict reading of existing rules, nevertheless meeting a nearly unbroken string of defeat in litigation.[257]

Finally, in connection with the TCJA and the lead up to it, the business community won virtually unqualified victories in the enactment of "territoriality" and "repatriation." It is part of the mission of this article to demonstrate that GILTI, BEAT, and FDII are not significant "qualifications" to these victories. Although the Democratic members of Congress all but unanimously voted against the TCJA, the business community enjoyed a near monopoly of discussion in the general and financial press of the issues for years prior to the enactment of the TCJA, characterizing "territoriality" as essential to "restoring" competitive balance between United States-based and other enterprises, and "repatriation" as necessary to providing a capital base for the expansion of domestic job creation and business activity. The Democratic or progressive opposition gave only the quietest of voice to the quite substantial grounds for refuting such arguments.

In all these circumstances, it is possible to give a brief yet comprehensive statement of what United States policy is with respect to the taxation of international "intangible" income. That policy is that the amounts determined to be the "residual" income of multinational corporations—the excess of the total profits of an integrated group over the sum of all "marginal" returns accorded to the "functions, assets, and risks" which can be definitely associated with individual component enterprises of the group—should be virtually exempt from taxation by any country. This is true even though virtually no party would explicitly advance that proposition in those terms publicly. But it is the implicit policy of the United States, expressed both in contemporary statutory provision and in the outcome of disputes which arise in the area. It is certainly implicit in the adoption of a "territorial" system without serious tightening or enforcement of

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[257] *See*, *e.g.*, Xilinx, Inc. v. Commissioner, 598 F.3d 1191 (9th Cir. 2010); Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009), *nonacq.*, 2010-49 I.R.B. (Dec. 6, 2010); Amazon.com, Inc. v. Commissioner, 148 T.C. 108 (2017), *appeal docketed*, No. 17-72922, 9th Cir. *Cf.* Wal-Mart Puerto Rico, Inc. v. Zaragoza-Gomez, 834 F.3d 110 (1st Cir. 2016), aff'g, 174 F.Supp.3d 585 (D. P. R. 2016); Altera Corp. v. Commissioner, 145 T.C. 91 (2015), rev'd, 2018 U.S.App.LEXIS 20524 (July 24, 2018), opinion withdrawn, 898 F.3d 1266 (Aug. 7, 2018).

transfer pricing rules. It is implicit in the strict insistence on predicating transfer pricing analysis on "contractual terms" unilaterally determined by the central management of the private groups. It is implicit in the string of decisions by the courts circumscribing any administrative ambition in the interpretation or application of regulations. And it has been the principal objective of this article to show that, far from contradicting or undermining any such policy, the combination of apparently restrictive innovations of recent statute—the GILTI, FDII, and BEAT provisions—when closely analyzed actually reinforce the policy.

Nor is there realistic prospect of any change in this policy. Republican legislators and politicians are generally hostile to any effort that might increase the tax burdens of larger corporations. Democratic legislators have historically supported such efforts, but it was a Democratic Administration that hastened to restrain the international bodies from the material changes they initially advanced in the BEPS process. Moreover, there are increasing suggestions, particularly from the political "right," that the major United States technology companies have become some kind of favorites of the Democratic Party or the "left." There is considerable evidence of this, which includes the Obama Administration's effort to restrain BEPS, and the circumstance scrambles the traditional understanding of the politics of corporate taxation in general and transfer pricing in particular.

On the subject of the relationship of the technology companies with forces on either end of the political spectrum, there is another major set of considerations to take into account in assessing the future course of transfer pricing policy. It has long been recognized, and is emphasized especially by Professor Richard Vann of Australia, that transfer pricing is the core issue of international taxation and that it generates far greater "heat" than any other international tax issue.[258] It has been suggested, by myself and others, that this circumstance is generated not only by the substantial amounts of revenue potentially involved, but also by concerns about proprietary

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258 Richard J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 WORLD TAX J. 291 (2010).

and other nonpublic corporate information.[259] Formula apportionment could be administered only by permitting, indeed requiring, the tax authorities to gather a wide range of information about a global corporate group; and that information could or would be made available to the tax authorities of a wide range of countries.

Concerns about proprietary and nonpublic information can be expected only to intensify in the coming years. Enterprises situated in developed countries have for many decades possessed valuable technological and other proprietary information protected by their home country laws and the laws of other developed countries with which they do business. The country of whose enterprises this is truest is the United States. But developing or emerging countries have since then began to "emerge" after World War II, taking a more restrictive view of the protection of private information, particularly technological information, and frequently advocating "technology transfer" from the private companies to companies in their jurisdictions, or even to their governments. The question of protection of intellectual property and "technology transfer" are at the heart of the current ongoing trade discussions between the United States and China.

Increasingly and inevitably, the United States views China as its most important global competitor and views the advanced technology of United States based companies as among its most important long-term advantage in counterbalancing China's advantages in other areas, most notably China's far larger population. There is, without regard to this circumstance, a gulf between the views of the two countries in relation to transfer pricing: China, really alone among the G-20 countries, is willing to suggest openly the potential acceptability of formula apportionment, which would probably entail abrogation of the "separate enterprise" standard of the model and bilateral income tax conventions.[260] These problems of information gathering, information exchange, and technology protection can only widen and deepen this gulf, making real progress on the definition of the international tax base more, rather than less, problematical as time goes by. Indeed, these difficulties have in all likelihood

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[259] UNITED NATIONS, PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES, 10, 374: 2013 (2013) https://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf.

[260] *Id.*

already exerted influence in the matter. They probably lay behind the United States' delayed but ultimately adverse reaction to the BEPS initiative, and the transformation, before and during that initiative, of the role of the United States as the world's foremost champion of reform and progressive change in international transfer pricing policy, to the world's foremost obstacle to such change. For better or worse, the United States has become the latter.