

# Transfer Pricing After BEPS: Where Are We and Where Should We Be Going

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In October, 2015, the G20 and the OECD approved and issued a series of reports in their project on Base Erosion and Profit Shifting.<sup>1</sup> Transfer pricing issues formed a significant portion of the subject matter of those reports. The final report on BEPS Actions 8 – 10: *Aligning Transfer Pricing Outcomes and Value Creation*<sup>2</sup> contained nearly 200 pages of revisions to the OECD Transfer Pricing Guidelines.<sup>3</sup> The final report on BEPS Action 13: *Transfer Pricing Documentation and Country-by-Country Reporting*,<sup>4</sup> rewrote Chapter 5 of the OECD Guidelines, setting out a new coordinated approach to transfer pricing documentation and reporting, including a requirement that large multinational enterprises prepare and submit annually a country-by-country report of their income, taxes paid and certain indicators of economic activity.

The BEPS transfer pricing reports address a number of topics. However, they are directed toward one overarching objective: the alignment of the place where income is reported for tax purposes with the place of value creation. The first paragraph of the explanatory

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<sup>1</sup> See, OECD(2015), *Explanatory Statement*, OECD/G20 Base Erosion and Profit Shifting Project, OECD. [www.oecd.org/tax/beps-explanatory-statement-2015.pdf](http://www.oecd.org/tax/beps-explanatory-statement-2015.pdf) (hereafter the “Explanatory Statement”)

<sup>2</sup> OECD(2015), *Aligning Transfer Pricing Outcomes with Value Creation, Action 8 -10 – 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241244-en>. (hereafter the “Final BEPS Transfer Pricing Report”)

<sup>3</sup> OECD(2010), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing, Paris. (hereafter the “OECD Guidelines”)

<sup>4</sup> OECD(2015), *Transfer Pricing Documentation and Country-By-Country Reporting, Action 13 – Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241480-en>.

statement to the October 2015 BEPS reports suggests that the collective BEPS outputs constitute “a bold move by policy makers to ... ensure that profits are taxed where economic activities take place and value is created.”<sup>5</sup> The transfer pricing elements of the project are especially important parts of the G20 / OECD effort to meet this objective.

In the 2013 Action Plan that initiated the BEPS Project,<sup>6</sup> the G20 and OECD countries committed to focus attention on three transfer pricing problems that country representatives believed allow a separation of income from relevant economic activity under pre-BEPS interpretations of the arm’s length principle. These are: (i) the transfer of intangibles and other mobile assets for less than full value; (ii) the over-capitalization of low-taxed group companies; and (iii) contractual allocations of risk to low tax environments in transactions that would be unlikely to occur between unrelated parties. To address these problems, the G20 and OECD countries committed themselves in the Action Plan to the following work:

- Developing rules to prevent profit shifting by ensuring that inappropriate returns do not accrue to an entity solely because of its contractual assumption of risk.<sup>7</sup>
- Developing rules ensuring that inappropriate returns do not accrue to an entity merely because it has provided capital.<sup>8</sup>
- Developing rules ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation. This work was to include updates to the provisions of the OECD Guidelines on hard to value intangibles and cost contribution arrangements.<sup>9</sup>

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<sup>5</sup> Explanatory Statement, para. 1.

<sup>6</sup> OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264202719-en> (hereafter the “Action Plan”).

<sup>7</sup> Action Plan, Action 9, at p. 20.

<sup>8</sup> Ibid

<sup>9</sup> Action Plan, Action 8, at p. 20.

- Clarifying the circumstances under which transactions can be recharacterized or disregarded by tax administrations.<sup>10</sup>
- Clarifying transfer pricing rules related to profit splits and other transfer pricing methods in the context of global value chains.<sup>11</sup>

The Action Plan underscored the OECD's strong desire to find solutions to the perceived transfer pricing problems by inviting delegates to address those issues either under the arm's length principle or through special measures going beyond the arm's length principle.<sup>12</sup> While the various workstreams listed in the Action Plan were obviously interrelated, the work on risk, provision of capital or funding, and transfers of intangibles were the foundational elements of the BEPS transfer pricing work.

### **Separation of Risk From Business Functions**

The OECD Guidelines have long recognized that a party assuming a greater risk in its business dealings will tend to expect a higher return as compensation for assuming the risk.<sup>13</sup> This means that in transactions between associated enterprises, a member of an MNE group that assumes risk can expect a return that correlates with the level of risk it assumes, unless the risk factor plays out in a way that reduces or eliminates the return anticipated. While this correlation between risk and reward is a well-established transfer pricing principle, there was little general guidance in the pre-BEPS OECD Guidelines on how one determines which entities in an MNE group in fact bear specific risks. 2010 changes to the OECD Guidelines had provided some guidance on the allocation and transfer of risk in business restructuring

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<sup>10</sup> Action Plan, Action 10, at pp. 20-21.

<sup>11</sup> Ibid

<sup>12</sup> Action Plan, Actions 9 and 10, pp. 20 – 21.

<sup>13</sup> OECD Guidelines at para. 1.45.

transactions,<sup>14</sup> but there was little comprehensive treatment of risk in the general provisions of the OECD Guidelines. The BEPS work sought to rectify this perceived lack of clear guidance.

The Final BEPS Transfer Pricing Report begins by discussing how, as a general matter, one determines the actual terms and conditions of a related party transaction to be analyzed under the transfer pricing rules. The report suggests that one should begin with the terms, conditions, and allocations of risk contained in contracts and other written terms of the transaction in question.<sup>15</sup> However, if written terms are ambiguous or missing, or if the conduct of the parties differs from the transactional terms contained in the contracts, one must “accurately delineate” the transaction based on the conduct of the parties.<sup>16</sup> This delineation of the transaction requires a careful, detailed, facts and circumstances based functional analysis.<sup>17</sup>

One of the important factual circumstances to be considered in delineating the transaction relates to risk. The Final BEPS Transfer Pricing Report suggests that the allocation of risk follows the general conduct related rule on delineation of transactions. That is, a particular risk will be allocated to the party or parties in the MNE group that contractually assumes the risk, provided the relevant parties also conduct their affairs in a manner consistent with what the contracts say about the allocation of risk. At the heart of the factual investigation of how the parties’ conduct affects the determination of which entity or entities in the MNE group actually bear risk are two questions: (i) which party or parties control the risk; and (ii) which party or parties have the financial wherewithal to assume the risk.<sup>18</sup> The report suggests

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<sup>14</sup> OECD Guidelines at para. 9.17 – 9.46.

<sup>15</sup> Final BEPS Transfer Pricing Report, para. 1.60.

<sup>16</sup> Final BEPS Transfer Pricing Report, para. 1.43, 1.60.

<sup>17</sup> Final BEPS Transfer Pricing Report, para. 1.82 *et. seq.*

<sup>18</sup> Final BEPS Transfer Pricing Report, para. 1.86.

that unless a party controls the risk in question, and has the financial wherewithal to assume the risk, its conduct will not support an allocation of the risk to that party, even if contracts clearly assign the risk to that party. If these requirements are not satisfied, the risk will be deemed to be borne for transfer pricing purposes by entities within the MNE group which do control the risk and which have financial wherewithal to assume the risk.<sup>19</sup>

The Final BEPS Transfer Pricing Report defines what it means to control risk for this purpose. It suggests that there are three elements critical to the efforts of an independent business to manage its risks. These elements are: (i) making decisions to take on risk, lay off risk, or to decline to undertake a risk bearing opportunity; (ii) making decisions regarding how to respond to the risks arising in connection with a business opportunity, and (iii) making decisions regarding the mitigation of risk by taking actions that affect risk outcomes. The first two of these the BEPS report defines as being the functions that control risk. Risk mitigation, however, is not a required element of control according to the BEPS Report.<sup>20</sup>

This categorization of risk related functions and the definition of control is quite arbitrary and is not always clear. Under these rules, however, a party must have the capacity to make, and must actually make, some of the risk controlling decisions of the MNE group in order to claim that it bears that risk in the accurately delineated transaction. If there is no capacity to control risk, that is if all decisions related to risk are made elsewhere in the group, the entity will not be treated as having assumed the risk and will not be entitled to any risk related premium return from the business transactions that are the subject of the transfer pricing analysis. Thus, in line with the income alignment objectives of BEPS, risk and risk premiums will go to the entities

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<sup>19</sup> Final BEPS Transfer Pricing Report, para. 1.98 – 1.99.

<sup>20</sup> Final BEPS Transfer Pricing Report, para. 1.65.

performing the income producing activity of controlling risk; a low-function entity, with no capacity to control risk or make risk related decisions, will not be treated as bearing risk and will not be able to claim returns based on mere contractual allocations of risk.<sup>21</sup>

Tax planning strategies related to risk have involved allocating risk to low tax environments in order to claim that tax-advantaged entities in the group are entitled to significant income as compensation for bearing risk. While in the past some have thought that such allocations of risk could be achieved merely by adopting contracts specifying where the risk is allocated, following BEPS the critical question will be how much and what type of decision making capacity must be present in a particular entity in order to support the contractual risk allocation and establish that the entity controls its risks.

A careful reading of the BEPS changes to the Guidelines on risk suggests that the required level of activity to support a finding of control may not be terribly significant. While paragraphs 1.65 and 1.66 of the BEPS Report make it clear that some actual participation in decision making is required, paragraph 1.94 makes it clear that this decision making function can be shared with other entities. That paragraph also suggests that where the decision making responsibility is shared, as long as some decisions are taken by the entity contractually assigned the risk, no further inquiry is required to confirm that that party will be treated as bearing risk for transfer pricing purposes.

Thus, to assign risk to a tax-advantaged jurisdiction, there must be some decision making in that jurisdiction. However, not all risk control decisions must be allocated to the party contractually assigned the risk.<sup>22</sup> Other entities may assist in controlling risk by performing even

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<sup>21</sup> BEPS Final Transfer Pricing Report, para. 1.98 – 2.06.

<sup>22</sup> BEPS Final Transfer Pricing Report, para. 1.93 – 1.94.

important control functions. It is not even necessary that a majority of the control function be in the tax-advantaged entity.<sup>23</sup> The OECD Guidelines as revised by the BEPS Report do indicate that parties other than the one contractually assigned a risk must be compensated for any control functions they undertake, and that if those functions are important they may entitle the party performing the control function to a share of the risk related profits of the enterprise.<sup>24</sup> But apart from this obligation to compensate other entities assisting with control, the BEPS Report seems to require only that the tax-advantaged entity be contractually assigned a risk and perform some modest portion of the control function related to that risk.<sup>25</sup>

Two questions come to mind in connection with this treatment of risk. The first is whether the control requirement as described in the Final BEPS Transfer Pricing Report will actually be effective in encouraging alignment of income and value creation. It seems that the control test as it has been framed is quite a tame anti-abuse measure and that a standard based on the performance of only some control functions will be quite easy for taxpayers to satisfy if they are determined to allocate risk-based profits to tax advantaged environments. The threat to require profits based compensation to entities that are not contractually assigned risks, but that perform control functions on behalf of the risk-bearing entity, may limit the distortions that can be generated. But the standard for the level of risk control activity that must migrate to a low-tax environment in order to assign at least some risk premium to the low-tax entity seems quite modest and a requirement that should be easy to satisfy.

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<sup>23</sup> Ibid

<sup>24</sup> BEPS Final Transfer Pricing Report, para. 1.105.

<sup>25</sup> BEPS Final Transfer Pricing Report, para. 1.94.

The other question is whether the control requirement, even in the modest form described in the BEPS Report, will be enforceable. The new rules are implicitly based on an assumption that parties only assume risks if they actually control those risks. Business commentators on the new rules argued in the public consultation process that in dealings between independent enterprises it is common for one entity to assume and bear risks that they do not control, or do not fully control.<sup>26</sup> If the business commentators are correct and if examples can be brought forward showing that independent entities sometimes assume risks they do not control, then the control requirement fashioned by the OECD may impose a burden not fully consistent with the arm's length principle.<sup>27</sup> Whether courts, and particularly US courts, will be willing to sustain a government transfer pricing adjustment based on a reallocation of risk because of lack of control over the risk may become a contentious question.<sup>28</sup>

### **Separating Intangibles from the Creation of Intangible Value**

The OECD was well advanced in a long overdue project to rewrite the provisions of Chapter VI of the OECD Guidelines on intangibles when the BEPS exercise began. The intangibles project was rolled into the BEPS work, the primary objective being to update the existing guidance in order to better prevent below value transfers of intangibles that result in the separation of intangible value from the economic activities creating that value.<sup>29</sup>

The new chapter of the Guidelines on intangibles covers a wide range of topics. It sets out definitions that seek to fill gaps that exist in some countries' laws whereby items can fall

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<sup>26</sup> See also, Greg Ballantine, Tax Notes [cite]

<sup>27</sup> See, *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (July 27, 2015), *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005) *aff'd*, 567 F.3d 482 (9<sup>th</sup> Cir. 2009).

<sup>28</sup> See Schler, [cite]

<sup>29</sup> Action Plan, Action 8, p. 20.



outside a definition of intangibles, and therefore arguably be transferred with little or no compensation under transfer pricing rules, and yet give rise to significant income in the hands of the transferee.<sup>30</sup> The intangibles rules also clarify how business synergies and features of local markets are to be treated in transfer pricing analyses,<sup>31</sup> and overtly approve the use of common valuation techniques in a transfer pricing analysis in an effort to provide some way forward when it is impossible to identify reliable comparables because of the unique nature of the intangibles in question.<sup>32</sup>

While these elements of the new intangibles chapter of the OECD Guidelines may prove to be important, the most contentious portion of the new intangibles guidance relates to the treatment of intangible ownership and the entitlement of various members of the group to returns derived by the MNE group from the exploitation of intangibles. It is in this section of the report that the OECD seeks to achieve greater alignment between intangible returns and the contributions of various group members to intangible value. As with risk, the new provisions on intangible ownership suggest that a transfer pricing analysis where intangibles are present should begin with the relevant contracts and agreements. A party treated as the owner of the intangible under such contracts will be treated as the owner of the intangible for transfer pricing purposes.<sup>33</sup> However, the determination of contractual or legal ownership of the intangible is not treated as being particularly important to the question of how intangible related income should be allocated.<sup>34</sup>

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<sup>30</sup> Final BEPS Transfer Pricing Report, para. 6.2, 6.5 – 6.6.

<sup>31</sup> Final BEPS Transfer Pricing Report, para. 1.157 – 1.163.

<sup>32</sup> Final BEPS Transfer Pricing Report, para. 1.153 – 1.180.

<sup>33</sup> Final BEPS Transfer Pricing Report, para. 6.40.

<sup>34</sup> Final BEPS Transfer Pricing Report, para. 6.42 – 6.46.

The new BEPS guidance provides that associated enterprises contributing to the value of the intangibles must be rewarded by the intangible owner for those contributions. Contributions to intangible value can come in the form of the performance of functions, the provision of assets including, importantly, funding for intangible development, or the assumption of risks. The rewards to entities providing such contributions may be substantial and, particularly for important management and control functions, may justify compensation based on a share of the profits derived from the exploitation of the intangible.<sup>35</sup> In this way, the report seeks to reverse a perception that the owner of a key intangible can claim all of the residual profit of the business after rewarding certain low-risk or routine functions. Instead the parties performing critical functions related to the development and exploitation of the intangibles may be entitled to substantial rewards for their contributions.<sup>36</sup>

The focus on important contributions, including the so-called DEMPE functions, is reflected in several examples in the Appendix to the new Chapter VI. One important example, Example 6 in the Appendix, describes a situation where two associated enterprises embark on a joint intangible development project. One party owns the intangible and provides the funding for the development. It performs the functions necessary to control its financing risk. The other party manages the development project, performs all the relevant research activities, controls the development risks, and is responsible for exploiting the intangible once the development is complete. Hence, it performs most, if not all, of the DEMPE functions. Under these

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<sup>35</sup> Final BEPS Transfer Pricing Report, para. 6.50 – 6.58.

<sup>36</sup> In the wake of the BEPS Report and its focus on functions, these critical functions have been referred to by some as DEMPE functions. While that term is not used in the BEPS Report, the report does refer repeatedly to functions related to the Development, Enhancement, Maintenance, Protection and Exploitation of intangibles, hence DEMPE.

circumstances, the largest share of the anticipated returns from exploiting the intangible are allocated to the “doing” participant, rather than to the “owning” participant.<sup>37</sup>

The guidance on the rewards to be provided to entities contributing to the development and exploitation of intangibles is underscored by new provisions on cost contribution (cost sharing) arrangements (“CCAs”) and hard to value intangibles. The changes to the provisions of Chapter VIII of the OECD Guidelines on CCAs seek to impose the same rules on arm’s length compensation for control of risk, reward of contributions, and compensation for services as apply to non-CCA transfer and use of intangibles under Chapter VI. The ability of an entity to claim high returns for what is essentially a cash only contribution to a CCA is thereby severely restricted and the importance of functions that control risk and contribute directly to intangible value is emphasized.<sup>38</sup>

Similarly, rules on hard to value intangibles allow governments under some circumstances to rely on post-transfer financial results of the transferee of an intangible to value the intangible at the date of the transfer. The rules are pitched as being necessary to rectify situations of information asymmetry and can usually be avoided by adequate information disclosure. However, the rules will likely have the effect of bringing other countries more closely into line with practice under the US commensurate with income principle.<sup>39</sup>

As with the new rules on risk, the new provisions of the OECD Guidelines on intangibles have a tendency to push at the boundaries of the arm’s length principle. The rules on hard to value intangibles permit tax authorities to refer to information that an independent

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<sup>37</sup> Final BEPS Transfer Pricing Report, Chapter VI Appendix, para. 14 – 15.

<sup>38</sup> Final BEPS Transfer Pricing Report, para. 8.1 *et. seq.*

<sup>39</sup> Final BEPS Transfer Pricing Report, para. 6.186 – 6.195.

enterprise would not have had to determine arm's length prices. The rules on CCAs arguably overlook situations where independent parties do in fact adopt arrangements in which development costs are shared while one of the parties is primarily a cash contributor. In some situations, it may be argued that the approach to compensating DEMPE functions may create variable arms' length values for contributions in very similar factual contexts. The rules on accurate delineation of transactions may give tax administrations added authority to disregard taxpayers' intangible development or transfer transactions in situations where unrelated parties would not have such flexibility.<sup>40</sup>

### **Income Shifting Through Funding Arrangements Involving Overcapitalized Entities**

A further transfer pricing problem noted in the BEPS Action Plan involves the overcapitalization of low-tax, low-function entities and the use of that excess capital by such cash-box entities to provide financing or funding to other group entities, resulting in the shifting of income. For example, an MNE group could overcapitalize a low-tax entity and have it lend money to more highly taxed group members, shifting income out of high tax locations and into low tax locations through interest payments. Such entities might also invest their excess capital in valuable income producing assets or, of particular concern in the BEPS work, use that capital to fund the development of high value intangibles.

The term "overcapitalization" is not defined or described in the Action Plan and is largely ignored in the final BEPS Report. In particular, no effort is made in the BEPS Report to articulate standards for determining an arm's length level of capital for a single entity in an MNE

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<sup>40</sup> See, e.g. Example 16, Final BEPS Transfer Pricing Report, Chapter VI Appendix, para. 54 – 58, recharacterizing a purchase of an intangible as a financing transaction because the buyer lacks the capacity to make decisions regarding future development of the intangibles. Notably this recharacterization does not seem to require a finding that the transfer documented by the taxpayer was commercially irrational. It requires merely a finding that the transferee does not control its contractual risks.

group<sup>41</sup> or to regulate contributions of capital or capital assets between members of the group.<sup>42</sup>

To address the overcapitalization issue raised in the Action Plan, the BEPS Report turns its attention exclusively to determining the appropriate arm's length return to an entity providing funding. In doing so, the BEPS Report returns to its analysis of risk as the primary consideration in determining the proper reward for funding.<sup>43</sup>

The new guidance establishes three categories to describe the levels of risk undertaken by a funding entity and the resulting returns to which the funding entity is entitled. The first of these categories is described as an entity which does not have the capacity to and does not in fact evaluate and make decisions regarding its own funding arrangements. Such a classic, low-function cash-box entity is described as an entity which does not bear any risk for transfer pricing purposes because it fails the control requirement described above. Since it does not actually bear risk, such an entity is entitled to no more than a risk free rate of return from its funding.<sup>44</sup> While the report does not define what is meant by a risk free rate of return, that term should likely be interpreted as being the return an independent investor would receive for an investment in which it runs no or virtually no risk of losing its invested capital. The return anticipated from an investment in a high-grade bond issued by a strong government creditor would likely be the type of return the report appears to have in mind for such a funding arrangement.

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<sup>41</sup> Several countries, including Australia and the U.K., have sought to use transfer pricing rules to help regulate thin capitalization and excessive interest payments. The United States has generally not sought to use transfer pricing rules for this purpose and tends to believe that the definition of an arm's length level of capital through analysis of comparables is not likely to be a workable solution.

<sup>42</sup> The United States has, at times, sought to use transfer pricing rules to modify the consequences of capital contributions of income producing assets, with mixed results. See, e.g. Eli Lilly, GD Searle & Co., Central Cuba Sugar, Northwest Securities.

<sup>43</sup> Some countries objected to this funding return only approach and therefore insisted that the rules on disregard or recharacterization of transactions remain applicable to funding arrangements. See, Final BEPS Transfer Pricing Report, para. 1.105.

<sup>44</sup> Final BEPS Transfer Pricing Report, para. 1.85, 1.103.

The second category of risk and return involves an entity which has the independent capacity to make decisions about its funding arrangements (i.e. whether to take on, lay off, or decline to accept the risks associated with the funding) but which lacks the ability to control the underlying activities it is funding. Such an entity is described as “controlling its financing risk” but as not controlling the underlying development risk.<sup>45</sup> Such an entity is entitled, under the calculus of the BEPS Report, to earn a risk adjusted rate of return. While the determination of such a risk adjusted rate of return is not fully clear under the BEPS Report, it is indicated that reference to the entity's cost of capital and reference to other reasonably available alternative investments provide a guide to the determination of such a return.<sup>46</sup>

Nor is it clear at all what decision making capacity and independence is required to reach the threshold of controlling investment risk. In the context of a multinational enterprise, it will not be likely that officers of a subsidiary will have the ability to defy either the corporate management or the group's Board of Directors when the subsidiary is asked (or told) to make its accumulated capital available for corporate investment purposes, such as funding research and development. Declining an opportunity to fund a risky research and development project favored by management, and to instead invest in CDs or a casino in Macau, would not seem to represent a solid career move for the Treasurer of a subsidiary. But if such independence does not exist, does that mean that risk free returns are the best that can be expected for related party funding arrangements?

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<sup>45</sup> See, e.g. Example 6, Chapter VI Appendix, para. 14 – 15.

<sup>46</sup> Final BEPS Transfer Pricing Report, para. 6.62.

The final category of risk bearing involves an entity which both controls its financing risk and controls the underlying activity for which the financing is used. Thus, an entity funding research and development could enter this higher level of risk and return only if it could both make independent decisions about whether the funding should be provided and give informed direction to the course of research for which the funding is used. If it has the capacity to contribute to the control of both types of risk, it will potentially be entitled to a return higher than a “risk adjusted rate.” Its anticipated return will presumably include a participation in the future earnings derived from the investment.

The Final BEPS Transfer Pricing Report repeatedly notes that the funding returns it is describing are anticipated returns at the time of the investment, not the actual returns derived from the development activities.<sup>47</sup> It is suggested that differences between anticipated and actual returns are often present, and that a separate analysis is required to determine which of the entities is entitled to enjoy unanticipated benefits or bear unanticipated burdens associated with the difference between projected and actual returns. The Report says almost nothing about how an analysis of which entity is entitled to unanticipated returns is to be carried out. The answer presumably has something to do with which entity bears and controls the risks associated with either not meeting or exceeding the projections. But since the potential reasons for falling short of projections or for exceeding projections are likely numerous, and may lie entirely outside the control of any of the parties to the funding arrangement, the allocation of the difference between *ex ante* and *ex post* returns remains a near total mystery, one to which the Working Party apparently intends to turn its attention in the coming year.

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<sup>47</sup> Final BEPS Transfer Pricing Report, para. 6.69 - 6.70.

## **Potential Consequences of the BEPS Transfer Pricing Guidance**

The practical consequences of these changes in the OECD Guidelines for US based multinationals are challenging to evaluate. A number of factors need to be taken into account.

First, it does seem fairly obvious that to the extent countries around the world adopt and enforce these new principles in their local law, companies will have to deal with much greater complexity in their transfer pricing analyses and compliance. The new OECD guidance requires detailed factual understanding of the nature of the risks faced by the business, how decisions related to those risks are made within the business, and which entities within a group are involved in making those decisions. That analysis of the mechanisms for managing and controlling risk has to be undertaken on a material risk by material risk basis. Not only is it necessary to understand how the parties to a controlled transaction manage and control the risks of doing business, it will also be necessary to consider how independent companies engaged in potentially comparable transactions address risks. The new OECD Guidelines make it highly relevant to determine whether such comparables bear the same risks as the parties in the tested transaction, and whether they control risks in the same way. Information needs regarding potential comparables will increase.

The same type of factual complexity will be required in matters involving intangibles. Careful factual attention will need to be paid to the contributions made by various associated enterprises to the creation of intangible value. While identification of which entities bear development risks related to intangible development presents one important line of now required factual investigation, it will also be necessary to consider which entities perform important development functions, including management and decision making regarding intangible development undertakings.



With greater factual investigation being demanded, the likelihood of controversy is virtually certain to increase. Where the rules require very close factual examination of all parties to a tested transaction and to all potential comparables, the possibilities for factual disagreements and disagreements over the meaning of the facts identified, are likely to expand.

Second, the new rules may have important impacts on the structures adopted by taxpayers for intangible development and ownership. These consequences are still difficult to predict. If one associated enterprise is the legal owner of an intangible, has the financial capability to develop and exploit the intangible, provides the relevant funding, bears and controls the risks associated with the development and use of the intangible, and has employees that perform the DEMPE functions, that affiliate is entitled to the returns from exploiting the intangible. If such an associated enterprise owns an intangible, has the financial capability to develop and exploit the intangibles and provides the relevant funding, but does not control the risks associated with its financing arrangement or with the intangible development project, and does not perform DEMPE functions, that enterprise will likely be entitled to no more than a risk free rate of return on its funding.<sup>48</sup>

What outcomes arise between these two fairly clear endpoints are quite uncertain. For example, where an associated enterprise performs DEMPE functions but lacks capacity to develop and exploit the intangible, or where one associated enterprise controls some but not all risks related to development, or where DEMPE functions are split among multiple affiliates each having financial capacity, or each bearing and controlling some risk, the intended outcomes are rather unclear. Through some combination of accurate delineation of transactions and providing compensation for important development functions or risk controlling functions, the intent seems

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<sup>48</sup> See, e.g., BEPS Final Transfer Report, Chapter VI Appendix, Example 16.

to be that members of the group will arrive at an equitable sharing of the fruits of exploiting developed intangibles. Exactly how that outcome will occur, however, is difficult to describe. Indeed, it is notable that the recently released discussion draft on profit split methods<sup>49</sup> somewhat surprisingly does not necessarily recommend that profit splits be used in such circumstances. Indeed, in its current form that draft seems to narrow the circumstances in which profit split methods can be applied rather than encouraging greater reliance on profit splits. One is left to a not insignificant amount of head scratching to understand what exactly companies or tax administrations should do to administer these rules.

Third, the uncertainty created by the new rules is compounded by the suspicions, described above, that the direct correlation between control of risk and bearing of risk upon which the new rules seem to be premised may not always exist in transactions between independent entities. Some will certainly contend that the BEPS guidance does not, despite its protestations to the contrary, strictly conform to the arm's length principle. There may in fact be transactions between independent enterprises where a more or less passive investor funds intangible development costs and earns part or all of the return from the exploitation of the intangible after compensating those entities performing DEMPE functions. There may also be transactions where such passive, non-risk controlling enterprises lose their investment in a failed development exercise. If that is the case, particularly given recent movements in US case law,<sup>50</sup> a serious question may arise as to whether courts will enforce the imposition of a government transfer pricing adjustment premised exclusively on a lack of control over risk.

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<sup>49</sup> *Discussion Draft on the Revised Guidance on Profit Splits*, July 4, 2016, OECD.

<sup>50</sup> *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (July 27, 2015), *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005) *aff'd*, 567 F.3d 482 (9<sup>th</sup> Cir. 2009).

If the new rules are challenged in the courts as being inconsistent with the arm's length principle, the status of the OECD Guidelines will become a topic of intense debate. The Guidelines do not constitute part of US domestic law. They are referred to occasionally by the courts, but do not constitute authority for interpreting section 482. The United States, however, is a member of the OECD and is bound to follow its authoritative formal recommendations, at least in interpreting its treaties in dealings with other OECD countries. While most U.S. treaties do not explicitly refer to the OECD Guidelines as a basis for dispute resolution,<sup>51</sup> it can be expected that the U.S. Treasury will not affirmatively concede that there is a difference between the arm's length principle as interpreted under domestic law and the same principle as interpreted in the OECD Guidelines. The IRS will, therefore, likely seek to follow the OECD Guidelines in resolving international tax disputes under treaties. Other countries likewise will follow the OECD Guidelines, and may formally incorporate the principles of the Guidelines in their domestic law.

As a result, many companies will seek to conform their practices to the demands of the Guidelines on control of risk and performance of DEMPE functions. Knowing precisely how to do so may be more challenging, however. Obviously some companies will shift functions to low-tax environments in an effort to establish a sufficient level of control. The fact that the new rules do not require all of the control of risk, or all of the DEMPE functions, to be in a low-tax entity in order to establish in such an entity a claim to most of the returns derived from intangibles or most of the risk premium will lead to uncertainty over what functions will need to move. One can anticipate the export of some jobs in response to BEPS, but how many and which jobs companies will feel compelled to move remains uncertain.

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<sup>51</sup> The treaty with Japan is an exception to this general statement.

The uncertainty and the complexity of the place the transfer pricing rules have landed after BEPS is unsatisfactory. The rules almost certainly will be hard to administer, hard to comply with, and will lead to increased controversy. That being the case, the current stopping point in the evolution of the arm's length principle is likely unstable and there may be a reason to consider in the near term whether a better alternative exists. The next section of this paper turns to some possibilities.

### **Alternatives to Transfer Pricing Methodologies**

The highly uncertain and often contentious nature of today's arms-length pricing regime post-BEPs should be compared to other alternative methods of allocating multinational income among taxing jurisdictions. In this country these alternatives have historically focused on three factor combined unitary formulary apportionment similar to the approach used in many states of the United States.<sup>52</sup> In the European Union the primary focus has been the European Commission's development of the Common Consolidated Corporate Tax Base, which also applies a multi-factor formula apportionment.<sup>53</sup> The problems of adapting the U.S. state alternatives have been well documented.<sup>54</sup> Walter Hellerstein, among others, has described many of the distortions inherent in the CCCTB.<sup>55</sup> These problems and distortions have led more recent commentators to focus on a sales-based apportionment or allocation of residual profits.<sup>56</sup>

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<sup>52</sup> Walter Hellerstein, *State Taxation*, 3d ed. (Warren, Gorham & Lamont 2013 rev).

<sup>53</sup> European Commission Proposal for a Council Directive on a Common Consolidated Corporate Tax Base 2011/0058 (CNS), 16 March 2011, (hereinafter referred to as "2011 CCCTB")

<sup>54</sup> Julie Roin "Can the Income Tax Be Saved? The Promised Pitfalls of Adopting Unitary Formulary Apportionment" 61 *Tax Law Review* 169 (2008).

<sup>55</sup> Walter Hellerstein "Formulary Apportionment in the EU and the US: A Comparative Perspective" in *Tax Mobility* (A. Dourdo ed.) International Bureau of Fiscal Documentation, September 2013.

<sup>56</sup> Proposals by Durst et al and Devereux et al, both focus on residual profits. See Reuven S. Avi-Yonk, Kimberly A. Clausung and Michael C. Durst "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split", 9 *Florida Tax Review* 5 (hereinafter "Durst et al"); and Michael Devereux et. al., <http://www.taxpolicycenter.org/event/corporate-tax-21st-century>.

Nonetheless a brief review of the problems of multi-factor formulary apportionment proposals is useful followed by a more detailed discussion of the issues related to residual profit apportionment or allocation proposals. These proposals, each of which substantially alter the amount of income attributable to any specific affiliate in a multi-national group, should then be compared to the current regime of transfer pricing after BEPS, including any improvements that can be made to that regime.

The discussion below ignores two important sectoral issues: the treatment of financial institutions and the treatment of the exploitation of natural resources. Both can be reasonably resolved, but the nature of that resolution depends in large part on the broader system for allocating income. Thus a discussion of these sectoral issues is left for another day.

### **Combined Unitary Multi-Factor Formulary Apportionment**

Much academic study has been devoted to applying a variant of the combined, unitary formulary apportionment regimes adopted by many U.S. states (and by Canadian provinces) to global income of multinationals.<sup>57</sup> The paradigm for these regimes is determining a single tax base by combining the income of multiple related legal entities operating a unitary business and then apportioning that tax base according to three factors: payroll or another measure of employment, property and sales. The 2011 European Commission Proposal for a Common Consolidated Corporate Tax Base (“CCCTB”) was proposed to be optional for EU resident corporations.<sup>58</sup> The proposal would combine the income of all related entities resident in EU countries and apportion that income among EU resident entities based on an

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<sup>57</sup> See, e.g., Joann Martens-Weiner, *Company Tax Reform in the European Union: Guidance for the United States and Canada on Implementing Formulary Apportionment* (2006).

<sup>58</sup> 2011 CCCTB, Note 53.

apportionment fraction weighted one-third to sales, one-third to assets (generally using tax-book value), one-sixth to payroll and one-sixth to employee headcount. The proposal has attracted relatively little interest beyond academia. It was revived by the European Commission in the wake of BEPS in 2015.<sup>59</sup> The Commission now proposes that it be considered as a mandatory proposal, but implemented in steps, the first of which is achieving a common tax base, which was released in proposed directive form on October 25, 2016.<sup>60</sup>

As the history of the CCCTB indicates, the difficulties of adapting an apportionment regime to a regional much less a global context should not be underestimated. Establishing such a regime requires multilateral resolution of three basic design issues: what is the set of business income to which an apportionment formula should be applied, how is the income subject to the formula measured, and what factors should be included in the formula. Each of these design issues are discussed separately below.

**Identifying Business Income Subject to Separate Apportionment.** While many states apply formulary apportionment only to the income of a single separate legal entity, in the international context apportionment only makes sense if the various legal entities in the controlled group of companies are combined; since most legal entities in multinational groups do not operate in multiple countries, formulary apportionment as applied to a single legal entity would accomplish little—and would leave today’s transfer pricing regime as the mechanism that divides up group income among legal entities. Given combined reporting of multiple affiliates, the question then arises should the income of the entire multinational group be combined and subject to a single apportionment or should separate apportionment be undertaken for each so-

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<sup>59</sup> European Commission, Communication to the European Parliament and The Council: A Fair and Efficient Corporate Tax System in the European Union Com (2015) 302, June 17, 2015.

<sup>60</sup> European Commission, Proposal for a Council Directive on a Common Corporate Tax Base, COM (2016) 685 final, October 25, 2016 (hereinafter "2016 CCCTB").

called “unitary” business of the group. Either way losses would, of course, be taken into account, which apparently was one of the reasons some multinationals supported the CCCTB.<sup>61</sup> One study estimates losses would reduce the global tax base by as much as 12%.<sup>62</sup>

Applying the formula to groupwide income would be simpler and perhaps for that reason more likely to achieve uniformity among implementing jurisdictions. The 2011 CCCTB adopts that approach.<sup>63</sup> However, applying the formula separately to each unitary business, as is done by many states,<sup>64</sup> would more accurately allocate income to the functions and activities that create it: pharma companies, for example, have quite different margins for their prescription pharmaceutical businesses than for their generics or consumer products businesses. But the experience of U.S. states illustrates that what constitutes a unitary business can be very subjective and thus give rise to disputes.<sup>65</sup> Technology companies, for example, are often a combination of hardware, software and services that are sometimes bundled but other times sold separately. Getting multilateral agreement on how to divide multinational groups along the lines of separate unitary businesses is likely to be a daunting task; different countries are likely to take different approaches depending on what yields the most revenues for their coffers.

**Measuring Income Subject to Apportionment.** Once the business unit subject to apportionment is determined, the relevant combined income of the legal entities must be measured. Particularly if the apportionment is determined on a groupwide basis, it is tempting to

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<sup>61</sup> See, Sol Picciotto, Taxing Multinational Enterprises as Unitary Entities, 82 Tax Notes 895 (May 30, 2016) at p. 912.

<sup>62</sup> Alex Cobham and Simon Loretz "International Distribution of the Corporate Tax Base: Implications of Different Apportionment Factors" ICTD Working Paper 27 (2014).

<sup>63</sup> 2011, CCCTB, Articles 54 – 58.

<sup>64</sup> See Hellerstein note 52, pages \_\_\_\_

<sup>65</sup> See, e.g., Charles E. McLure, Jr., "Operational Interdependent Is Not the Appropriate 'Bright Line Test' of a Unitary Business – At Least Not Now", 18 Tax Notes 107 (Jan. 10, 1983).

suggest that financial statement income be used as the base for apportionment. However, financial statement income, whether conforming to IFRS, Japanese GAAP, U.S. GAAP or some other financial accounting system, provides considerable flexibility for multinational groups to choose methods of booking revenues and expenses in ways that may not be acceptable to tax authorities.<sup>66</sup> Revenue recognition policies, reserve policies, amortization and depreciation policies can vary from one multinational group to another as long as they are fully disclosed and consistently applied over time.<sup>67</sup> It would seem unlikely that legislatures and tax authorities would be willing to have their corporate tax base determined by such flexible policies. And of course, notwithstanding considerable efforts over the past several years, the efforts to conform IFRS with U.S. GAAP and similar systems in Japan and other countries show no sign of succeeding, creating dissimilar treatment for many multinationals headquartered or trading in different jurisdictions.

If financial statement income is rejected as the best measure of income to be apportioned, then some common measurement of taxable income would need to be developed. Today the measurement of taxable income differs enormously from one country to another: revenue recognition, methods of inventorying costs, schedules for depreciation or amortization of tangible and intangible property, use of mark-to-market accounting, treatment of original issue discount, circumstances in which the sale or other transfer of business assets or subsidiary stock trigger income—all today differ substantially from one country to another.<sup>68</sup> Under today's arms-length pricing regime, taxpayers can be expected to cope with these differences because

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<sup>66</sup> Roland Murphy and Prek Sikka "Unitary Tax Base and the Role of Accounting" ICTD Working Paper 34 (2014).

<sup>67</sup> Id

<sup>68</sup> Id



they only apply to the income of an entity doing business in that country. But consolidated reporting applies to all entities engaged in the same unitary business. That means global consolidated income for each unitary business would need to be separately calculated taking into account the measure of taxable income as determined by each country to which the unitary business must report its income. If countries do not agree to a common tax base, an enormous effort would be required to apply the formula apportionment regime in various countries.<sup>69</sup> The 2016 CCCTB common tax base proposal does not comprehensively deal with many timing issues but contains a number of provisions that are not likely to be adopted consistently by other countries, including a participation exemption for affiliate dividends and gains from the sale of affiliate stock, a super deduction for R&D expenditures, a limitation on interest deductions in excess of 30% of EBITDA, and a notional interest deduction against book equity capital.<sup>70</sup>

Besides the measurement of taxable income, each country would need to develop rules on how to treat intercompany transactions within the combined reporting group. Should each entity calculate its income and then that income be aggregated to determine group income or should a true consolidation that ignores, for example, intercompany transactions, be adopted? If the former, how should losses be treated? The 2011 CCCTB proposes a true consolidation, ignoring intercompany transactions.<sup>71</sup> These issues must be consistently resolved by various countries if formulary apportionment is to be a practical alternative to today's transfer pricing regime.

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<sup>69</sup> Roin, note 54, at P. 200.

<sup>70</sup> 2016 CCCTB, note 60.

<sup>71</sup> 2011 CCCTB, note 53, Article 59.

As mentioned above, the European Commission is now focusing its efforts on the issue of developing a common tax base. Reflecting on this approach, some recent commentators have suggested that regional agreements or treaties might provide a path of agreement on a common tax base to implement formula apportionment.<sup>72</sup>

**Apportionment Factors.** If adopting consistent concepts of what businesses should be combined and how their income should be calculated seems difficult in the multilateral context, adopting apportionment factors in at least a somewhat consistent manner could be even more daunting. As described above, the 2011 CCCTB, similar to many U.S. states historically, proposed three equally weighted factors: employees (under the CCCTB determined half by headcount and half by payroll), property and sales.<sup>73</sup> Each raises design issues and creates incentives for manipulation that must be understood.

**Employee Headcount and/or Payroll Factor.** Each of these two potential factors require grappling with employee versus independent contractor issues. The 2011 CCCTB leaves it to the laws of each country to define what constitutes employment but does include a provision dealing with secondments of employees between related entities and an anti-abuse rule applicable to individuals that perform "tasks similar to those performed by employees."<sup>74</sup> In the United States we see how difficult these issues can be, how much flexibility businesses have in choosing alternative business models, and how technology is increasing that flexibility in today's economy. The judicious use of independent contractors in high tax rate countries and a similar use of employees in lower tax rate countries could conceivably yield tax reductions significantly

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<sup>72</sup> Picciotto, note 61, at p. 913.

<sup>73</sup> 2011 CCCTB, note 53, Article 86.

<sup>74</sup> 2011 CCCTB, note 53, Article 90.

in excess of any cost differentials.<sup>75</sup> The employee/payroll factor can also influence decisions whether to outsource back office and other routine functions versus bringing them in house. Even more important functions such as lower level software development, pharmaceutical clinical testing and routine manufacturing can efficiently be outsourced if tax considerations are taken into account. These problems are perhaps more prominent if headcount rather than payroll is the measure of employment because outsourcing and the use of independent contractors is most feasible for relatively low paying employee activities. But using payroll as a measure raises the issues of how to deal with stock-based compensation. The exclusion of such compensation seems inappropriate; yet its inclusion creates serious measurement issues and can create substantial distortions of the factor in specific years. Given different concepts of the tax treatment of stock-based compensation in different countries, it is very difficult to see how any consensus on its treatment would be achieved; the 2011 CCCTB, for example, measures compensation by the amount which is deductible under the laws of the member state applying the formula.<sup>76</sup>

There is really no good way to minimize the ability of taxpayers to manipulate the employee/payroll factor through outsourcing and independent contractors: somewhere the line between what is counted and what is not counted must be drawn and multinational groups are inevitably in a position to tailor their business structures at least around the edges to minimize income in higher tax rate jurisdictions and maximize their income in tax-favored jurisdictions.

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<sup>75</sup> Roin, note 54, at p 205 – 206.

<sup>76</sup> 2011 CCCTB, note 53, Articles 90 and 91.

Property Factor. The 2011 CCCTB defines this factor as fixed, tangible personal property.<sup>77</sup> It essentially includes factories, office buildings, warehouses and the like plus the equipment and furnishings that are used at these locations. The amounts taken into account are measured by historical cost less allowable depreciation; rents are capitalized to minimize distortions from decisions to rent versus of own.<sup>78</sup>

Under the 2011 CCCTB, the factor does not include inventories, accounts receivable, or intangibles generally; U.S. states typically include all tangible property, including inventories.<sup>79</sup> The reasons the 2011 CCCTB excluded each of these assets are apparent. Inventories and accounts receivable are highly mobile and thus easily manipulable. Self-developed intangibles raise serious valuation issues comparable to today's most serious transfer pricing issues; including purchased intangibles while excluding self-developed intangibles would seemingly distort the factor in an irrational manner

Yet the fact is that high margin companies typically have a relatively small portion of their value invested in fixed tangible assets. Moreover, what value they have in these assets can to a considerable extent be manipulated; third party contract manufacturing is common place in both the electronics and pharma industries.<sup>80</sup> The same outsourcing alternatives described above for manipulating the employee/payroll factor can be applied to alter the property factor. And, of course, those functions and activities that must be conducted directly by the multinational group can in many circumstances be moved to relatively low-tax

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<sup>77</sup> CCCTB note 51, Articles 92 – 94.

<sup>78</sup> Id

<sup>79</sup> Hellerstein, note 52.

<sup>80</sup> TBD

rate jurisdictions, in the same way today that companies are moving their DEMPE functions in those jurisdictions.

Because of these simple ways taxpayers can manipulate the employment/payroll and property factors for their benefit, and because the existence of these factors in a high tax jurisdiction can lead to a decline in functions and activities in that jurisdiction, most U.S. states have moved away from three factor apportionment. According to a recent study, in 1986 80% of the states used a variant three factor apportionment. By 2012 only 17% of the states did so.<sup>81</sup> All of the other states moved closer to a single sales factor, presumably based on the premise that sales were less subject to manipulation and less likely to discourage activity in that particular state.

Sales Factor. The sales factor raises several difficult issues,<sup>82</sup> including: the treatment of remote sales, the treatment of sales through intermediaries, the treatment of raw materials, components and intermediate goods, the treatment of capital goods and the treatment of services. These issues are novel in the income tax context, but not in the value-added tax context; the evolving thinking on these issues in the latter context can thus be a useful guide.

Sales made directly from a seller located in a different jurisdiction than the buyer raise serious issues. In the U.S. states, partly for Constitutional reasons, these sales cannot be taxed in the buyer's jurisdiction unless the seller has some physical nexus to that jurisdiction, . Sales in states with no physical jurisdiction are either "thrown out" of the apportionment fraction

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<sup>81</sup> Kim Clausing "Lessons for International Tax Reform From the U.S. State Experience Under Formulary Apportionment" ICTD Research Report 2 (2014).

<sup>82</sup> Other less difficult issues include what revenues are included as sales, including financial transactions, and when do transactions such as hedging transactions affect revenues as opposed to adjusting expenses. See, Hellerstein, note 55, at pp 7-8, 13-15.

or are “thrown back” to all other jurisdictions where the seller has both sales and nexus.<sup>83</sup> In the multilateral context these results could be unacceptable to countries with substantial remote sales (although the 2011 CCCTB proposal does include a variant of a throwback rule).<sup>84</sup> If so, the concept of a permanent establishment must be expanded substantially beyond anything contemplated by OECD or implemented by any country to date. Most broadly a seller would be determined to have a permanent establishment in a country if its sales to purchasers in that country exceed a certain minimum threshold without any other element of nexus.<sup>85</sup> That raises significant enforcement issues.<sup>86</sup> The enforcement issues can be reduced for remote sales to businesses, where a deduction disallowance or withholding tax mechanism can aid enforcement. But for remote consumer transactions the enforcement problem is significant. No doubt it can be expected that substantial multinational enterprises would comply with broadened PE rules independent of their nexus. Thus, the problem principally involves consumer purchases from relatively small and medium-sized businesses. Perhaps if the minimum thresholds for establishing a permanent establishment are set judiciously, enforcement issues could be reduced. Nonetheless, extension of the permanent establishment concept to apply to remote sales would require more extensive information exchange and ultimately cooperation on collection assistance from other governments.

Sales through third party intermediaries also raise significant issues. As an example most pharmaceutical companies sell to many U. S. customers through third party

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<sup>83</sup> Hellerstein, note 55, at pages 10 – 121. The states are prohibited from imposing tax where an out of state seller only solicits orders locally for approval in another state. 15 U.S.C. §381(a).

<sup>84</sup> The 2011 CCCTB throws remote sales – and sales to jurisdictions outside the EU – back to EU states where the multinational group has a presence, based on the groups relative employment and property factors. 2011 CCCTB, Article 96.

<sup>85</sup> Picciotto, note 61, at p. 911.

<sup>86</sup> Id..

distributors, such as Cardinal Health or McKesson. These purchasers at times today buy from manufacturers outside the United States and with proper tax incentives could probably structure operations to acquire even more of their inventory outside the United States. The same could be said for major retailers and major distributors in other industries. To avoid this potential for manipulation, sales to third-party distributors should be included on a basis that looks through to the ultimate retailer or consumer depending on the pattern of trade.<sup>87</sup> Accomplishing this requires reporting by the distributing purchaser to its sellers and to the relevant tax authorities; the system would likely require financial penalties, such as the loss of deductions for purchases or a withholding tax on payment for purchases, to incentivize the purchaser to maintain and report the necessary records. A look-through rule also requires that a seller to a third-party distributor be treated as being subject to tax in the jurisdiction of ultimate sale. In effect buy-sell arrangements with third-party distributors would be put on an equal footing with agency distribution arrangements for that purpose. Like with remote sales, such rules would expand the notion of permanent establishment substantially beyond anything currently contemplated by OECD or most countries. And as with remote sales, perhaps the rules should apply only for sales in excess of some floor to reduce the burden on taxpayers with relatively small sales.

Another difficult problem is the treatment of franchising and other licensing arrangements.<sup>88</sup> The decision to own hotels, restaurants or stores directly or to franchise them to third-parties, or to license a product to a local manufacturer versus contract manufacturing and selling the product directly, could clearly be influenced by a sales apportionment factor. Even if

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<sup>87</sup> Clausing and Avi-Yonah proposed a look-through rule for unrelated distributors in their single sales factor formulary apportionment proposal. Kim Clausing and Reuven Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment* (Brookings Inst. 2007).

<sup>88</sup> These difficulties are discussed in Harry Grubert, "Destination-Based Income Taxes: A Mismatch Made in Heaven" 69 *Tax Law Review* 57 (2015).

royalties are “sourced” by the jurisdiction of the franchisee’s or licensee’s activities, the difference in the magnitude of royalties earned versus the underlying sales revenues can be substantial. Given the lack of control exercised over third-party franchisees and other licensees, it is not clear that multinational businesses would change their business model for the sake of altering their apportionment factors in high tax jurisdictions, but the potential for such manipulation should be acknowledged.

Sales of raw materials, components or other intermediate goods to third-party manufacturers also raise the question of whether they should be treated on a look-through basis or whether the location of the sale should be the place where the goods are incorporated into products of the purchaser.<sup>89</sup> Here, however, the considerations are clearly different than sales to third-party distributors. Tracking the place of ultimate consumption of raw material, component or intermediate goods may be substantially more difficult compared to a distributor tracking the sale of its products, particularly where the purchased goods are transformed as typically happens with raw materials. In addition, the purchaser of the goods may have valid competitive reasons for not informing its seller of the location of its sales even if it could practically track them. It is difficult to see why distributors would have an equally valid concern. Indeed in many situations sellers expressly limit a distributor’s ability to sell into various markets to control its channels of distribution, thus having an explicit agreement regarding the location of sales.

For these reasons the location of sales of raw materials, components and other intermediate goods should be the location of their use by purchasing third-party manufacturers. Such a rule would provide purchasers of these goods an incentive to locate their manufacturing facilities in relatively low-tax jurisdictions if the benefit to the seller is sufficient to pass a

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<sup>89</sup> See Grubert, note 88, at pp 55-56.



portion of the savings on to the purchaser in the form of lower prices.<sup>90</sup> How widespread a phenomenon that would be is difficult to ascertain. Presumably because the tax rates are relatively low, studies of the migration of activities in the context of U.S. state taxes have not indicated that a particular problem exists. But at a minimum it would seem that any incentives for locating manufacturing facilities in a tax-favored jurisdiction to obtain better pricing from raw material, component and intermediate good suppliers would be substantially less than the incentive today to locate in such jurisdictions under the current arms-length pricing regime.

If a look-through rule is applied to sales to third-party distributors but no look-through is applied to sales to purchasers of raw materials, components and intermediate goods, a demarcation of the distinction between distribution and manufacturing would be required. The location, for example, of the final packaging or labeling of products can too easily be manipulated if a significant tax advantage results. Perhaps the current Subpart F definition of manufacturing<sup>91</sup> is as good a starting point in crafting such a distinction, although that definition has generated its share of controversy over the years.<sup>92</sup>

The sale of capital goods raises many of the same issues as the sale of intermediate goods, except that it seems even more apparent there is no practical way to look-through the purchase of capital goods to the location of sales of the products produced by those goods. If nothing else, given that the capital goods sale is taxable in the year of sale, any look-through would seemingly be based on projections of future sales that would inevitably be subjective and subject to substantial controversy. Thus, the sale of capital goods should be

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<sup>90</sup> Id. Grubert points out that in 2012 66% of U.S. exports were either "Industrial Supplies or Materials" or "Capital Goods". Consumer Goods accounted for less than 12%.

<sup>91</sup> See Treasury Regs 1.954-3(a)(4).

<sup>92</sup> Cite subpart F sales cases.

treated as located where the purchaser uses those goods. Again, such a rule could provide the purchaser with an incentive to locate its facilities in tax-favored countries where the seller of the good might be willing to offer a lower price. This incentive effect should be acknowledged. But it is likely to be a smaller incentive than that provided today under arms-length pricing.

The determination of the location of services raises even more difficult issues.<sup>93</sup> For U.S. state income tax purposes services are typically sourced in the location where the services are performed, not the location of the customer's use of those services. The 2011 CCCTB follows a similar path.<sup>94</sup> Presumably this sourcing is attributable to the difficulties in determining the location of the use of services by recipients of those services; indeed, in many cases, service recipients utilize the services of a provider in multiple jurisdictions. Today's transfer pricing regime provides one potential mechanism to deal with these situations by requiring that service recipients charge out the services costs to various affiliates benefitting from those costs. In these circumstances the service providers income could conceivably be apportioned to the various jurisdictions based on the service recipient's charge out of that amount. That would require the service recipient to provide information to the service provider at a minimum and could result in a negotiation of the allocation of service fees, in much the same way as today buyers and sellers negotiate the relative value of specific assets in a business asset acquisition. Given the frequency of services transactions where the service recipient benefits in multiple jurisdictions, this regime could be quite burdensome.

These difficulties could lead to the conclusion that for personal services where capital is not a material factor in producing income the place of performance may be the best

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<sup>93</sup> See Roin, note 54, at pp 208-209 and Hellerstein, note 55, at pp 9-12, for a discussion of these issues.

<sup>94</sup> 2011 CCCTB, note 53, Article 98

factor to utilize even if it does leave an incentive for those services to be located in tax-favored jurisdictions. Most personal services that involve minimal capital investment are not high margin activities. But some exceptions would no doubt be needed. One exception could be financial investment advisors. For that type of business perhaps the global trading model developed by the United States and the OECD could be adapted to determine the location of the relevant services.<sup>95</sup>

Other services, such as internet and transportation services, require relatively little employee activity and substantial capital investment. It is possible that for internet services activities generally the location of users can be tracked and business earnings sourced accordingly. That would require treating an internet service provider as having a permanent establishment in the jurisdiction of its users, a fundamental departure from the law today. For transportation services the jurisdictions in which the transportation is used by customers could be included in the sales factor, presumably with travel over the oceans being allocated on some basis.<sup>96</sup> These services create significant problems of sourcing and income allocation under today's arms-length pricing regime; the fact that they also cause similar problems under a sales factor should not be particularly disturbing.

Single Factor Sales Apportionment. The problems described above with the employment/payroll and property factors have led some commentators<sup>97</sup> to recommend that if formulary apportionment is to be adopted multilaterally, a single sales factor be utilized. That may be an improvement over three factor apportionment, but the problems with the sales factor

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<sup>95</sup> IRS Notice 94-40, Prop.Treas. Reg 1. 482-8.

<sup>96</sup> See, e.g. Code sections 861(d), 863 (c) and (d).

<sup>97</sup> Clausing and Avi-Yonah, note 87, provided such a proposal as part of the Hamilton Project.

described above would be substantially accentuated under a single factor apportionment. The potential incentive effects to purchase raw materials, components, and intermediate and capital goods in facilities located in tax-favored jurisdictions would be substantially larger, as would the incentives to provide personal services from such locations. Moreover, such a proposal would result in countries with substantial business production activity, but relatively small sales, collecting insignificant income tax revenues from those businesses. While countries attempting to attract business activity may be satisfied with that result, it seems in some sense an inappropriate result under an income tax and would certainly cause a very large shift in corporate tax revenues among various countries compared to today's arms-length pricing regime.

### **Residual Profit Sales Apportionment Proposal**

The above issues with various proposals to apportion total profits led Durst, Avi-Yonah, and Clausing<sup>98</sup> to propose that the formulary apportionment regime differentiate between “routine” profits and “residual” profits. In their proposal “routine” profits would be determined on a cost plus 7.5% mark-up basis and taxed where the costs are incurred.<sup>99</sup> That means the jurisdiction where activities and functions take place would be allocated out of the global income of a unitary business an amount of profit equal to 7.5% of the costs incurred in that jurisdiction (presumably proportionately less where the group earns less than a 7.5% markup on its costs). The remaining profit would be considered “residual” and would be allocated to the various jurisdictions on the basis of a sales factor.

This residual profit sales apportionment proposal has several advantages over the apportionment of all multinational income. First, the markup on costs could be set at a level

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<sup>98</sup> Durst, et. al, note 56.

<sup>99</sup> Id.

such that the incentives to move that cost to a low-tax jurisdiction based on earning a routine return are minimized. For example, with a 7.5% markup on costs, moving 100 of costs from a 35% to a 10% jurisdiction would only save about 1.9 of taxes; a tax savings equal to 2% of operating costs is unlikely to influence location decisions given other variables that are inevitably involved. Thus even a relatively modest mark-up on costs would mean that many businesses with low or even moderate margins would pay most if not all of their income tax to the jurisdictions where their activities and functions take place. For enterprises with high margins the tax in the jurisdictions of function and activities would be relatively modest but not insignificant. Residual profits would be allocated based on sales, leading to all the problems described above relating to the location and measurement of sales. But at least those problems would largely be limited to multinationals with relatively high margins. And, given the unpredictability of future profitability, the incentive effects could be lessened because location decisions are often made before the existence of high margins are predictable with certainty.

Of course, the above proposal starts with the combined income of affiliates constituting a unitary business. Thus, the problems described above in determining what constitutes a unitary business and how its combined income should be measured remain.

### **Residual Profit Sales Allocation Proposal**

In contrast to the above formulary apportionment proposals, Michael Devereux and others working as an informal group have been considering a proposal<sup>100</sup> that uses transfer pricing methodologies in a manner that allocates residual profits to the jurisdiction of sale. The proposal starts with the “entrepreneurial” model under today’s transfer pricing regime, under which a typical multinational group identifies one ‘entrepreneur’ affiliate to bear most of the

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<sup>100</sup> Devereux et. al, note 56.

risks (e.g. marketing and R&D funding risk) inherent in the group business and treats all other affiliates in the supply chain as engaged in routine activities and functions. The affiliates treated as engaged in routine functions earn returns on a cost plus or return on assets basis under transfer pricing methodologies based on third parties that bear little if any entrepreneurial risk. The residual profit then falls to the entrepreneur, which is typically resident in a tax-favored jurisdiction.

The residual profit sales allocation proposal essentially turns this transfer pricing model on its head and deems the country in which customer sales take place as the entrepreneurial affiliate. It ascribes routine profits to all jurisdictions in the supply chain except the market jurisdiction. The Devereux et. al. proposal provides that routine profits be determined under traditional transfer pricing cost-plus or return on asset methodologies, but routine profits could alternatively be determined based on a fixed mark-up in a manner similar to the Durst et. al. apportionment proposal described above. The proposal thus overrides intercompany contractual arrangements by imposing deemed arrangements to which transfer pricing methods are applied.

The Devereux et. al. proposal would essentially build up a transfer price through the supply chain based on actual legal entity costs and the allocation of a routine return to those costs. For example, an affiliate manufacturer would charge a price based on that manufacturer's activities and functions plus a mark-up, similar to a contract manufacturer. Any intermediate purchasing affiliate in the supply chain would also earn a routine return on its functions and activities which would then be reflected in its transfer price. The affiliate operating in the market jurisdiction would treat the amount determined above from its supply chain as its purchase price, to which it would add its costs in selling the product and measure its taxable income by the

difference between actual revenues earned on the sale of that product and the sum of these costs. Thus, product revenues and product-related costs would be determined on a separate accounting basis (i.e. tracing revenues and costs to specific products) rather than on any type of apportionment basis, but would impute contractual arrangements that deem the affiliate operating in the market jurisdiction as the group entrepreneur.

The Devereux et. al. proposal recognizes the need to "charge out" indirect costs, including R&D, G&A and certain marketing costs and suggests charging those costs to market country affiliates on a pro rata basis, similar to cost-sharing arrangements in the U.S. today (e.g. on the basis of relative sales revenues, gross income or some other similar metric). The charge out would include a services-type markup on the charged-out costs so that the affiliates performing these functions earn significant profits. Interest expense could then be allocated to all affiliates based on relative EBITDA or assets.

This separate accounting of revenues and direct costs, plus an apportionment of indirect costs, forces market country affiliates to bear the risks and rewards of the business related to the products they sell and earn any residual profits from those sales. All other affiliates, including affiliates performing R&D or G&A, earn a cost-plus or similar routine return.

### **Comparison of Durst, et. al. Residual Profit Sales Apportionment and Devereux, et.al. Residual Profit Sales Allocation Proposals**

The two residual profit proposals share a number of advantages and disadvantages. Both would substantially reduce the incentives for manipulation compared to other apportionment proposals and both reduce the incentives for the movement of functions and activities to tax favored jurisdictions compared to post-BEPS transfer pricing. Both create a more level playing field between resident and non-resident multinationals. Both require facing

up to the issues of remote sellers, seller of raw materials, intermediate and capital goods, sellers through third-party distributors, and the location of services activities. Both present issues in dealing with losses and with profit levels that fall short of routine returns. All of these problems require more thorough and detailed thinking than has been undertaken to date.<sup>101</sup>

From a U.S. perspective the revenue impact of each proposal is uncertain. Durst, et. al. project that their proposal would raise substantial revenues based on an assumption that U.S. profits would be approximately proportionate to U.S. revenues overall.<sup>102</sup> Grubert disagrees, pointing to the fact that royalties paid by U.S. multinationals today are twice the amount that R&D cost sharing payments would generate.<sup>103</sup> The mark-up on R&D under the Devereux et. al. proposal does not nearly make up that difference. However, Grubert does not take into account the fact that a portion of royalties earned by U.S. multinationals today relate to U.S. sales; those royalties would effectively continue to be taxed in the United States under either sales-based proposal. He also does not consider the revenue impact of charging out G&A (plus earning a mark-up under the Devereux et. al. proposal) attributable to non-U.S. sales. Finally, he does not take into account the fact that the United States would be taxing residual profits for the inbound transactions of foreign multinationals, which no doubt are substantial. Thus, on balance it seems most likely the Durst et.al. analysis is closer to being correct.

The Devereux et. al. proposal differs from the Durst et. al. apportionment proposal in a few key respects. First, it is a “bottoms up” rather than a “top down” proposal; by building up a transfer price based on the costs of and routine returns on functions and activities

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<sup>101</sup> Grubert, note 88, provides a critical review of all these issues.

<sup>102</sup> Durst et. al., note 56 at p. \_\_\_\_.

<sup>103</sup> Grubert, note 88, at p. \_\_\_\_.



throughout the supply chain, the proposal avoids the issues discussed above in determining what businesses are treated as unitary, what is the measure of combined income subject to apportionment and what revenues are included in a sales factor. Under the Devereux et. al. proposal, unitary business issues would apply but only in the determination of the allocation of R&D, G&A and other indirect expenses.

More importantly, by determining profit based on actual revenues and related expenses under separate accounting, the Devereux et. al. proposal results in sales jurisdictions with higher margins receiving a larger tax base and those with lower margins a lower tax base, compared to averaging of margins across all jurisdictions under the Durst et. al. proposal. In that way, for example, jurisdictions that permit higher prices for pharmaceutical products (like the United States) will receive higher than average tax revenues from their local sales. Similarly jurisdictions in which lower margins are realized, for example, because the local government does not vigorously enforce patent, trademark or other legal protections, would see a lower than average tax base. Further, when a multinational introduces a product into a new market incurring substantial start-up expense, the market country will only get incremental tax base as its local margin grows taking into account start-up costs.

These results seem more appropriate in the income tax context. That means the Devereux et. al. proposal would likely result in a lesser shift in a jurisdiction's tax base if adopted unilaterally, as is probable as an initial matter. Other countries continuing today's post-BEPS transfer pricing regime would still ascribe residual profits largely based on the multinationals' decisions where to place functions and risk. To the extent those functions and risks are in tax-favored jurisdictions, any resulting double taxation may not be a serious concern. In other situations the taxation of residual profits would lead to double taxation with high tax jurisdictions

with respect to imported products and less than full taxation with respect to exported products. It is not clear that a jurisdiction adopting either residual profit proposal would see that as such a bad result.

### **Destination-Based Cash Flow Tax**

The final alternative that should be discussed is the Destination-Based Cash Flow Tax (awkwardly referred to as the “DBCFT”). The tax has been discussed in academic circles for many years,<sup>104</sup> including most recently as an alternative proposal by the informal Devereux group.<sup>105</sup> It was proposed in 2005 by President Bush’s Tax Reform Advisory Panel.<sup>106</sup> Most recently it has been proposed by House Republicans as part of the 2016 Blueprint.<sup>107</sup>

The proposal is essentially a subtraction-method VAT with a deduction for domestic wages. It is a destination-based tax,<sup>108</sup> meaning that imports are not deductible to U.S. purchasers and exports are exempt from tax. Domestic wages are deductible without regard to whether they relate to imports, domestically produced goods, or exports.

From an economist's perspective the proposal is efficient because it does not tax basic returns to labor or capital but is limited to taxing “rents” or excess returns. Because it is destination based, no transfer pricing is required. The problems with the apportionment and residual allocation proposals above related to sales to distributors and sales of raw materials, components, and intermediate and capital goods disappear because the purchaser of all such

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<sup>104</sup> See, e.g., David Bradford, "The XTax in the World Economy," Griswold Center for Economic Policies working paper No. 93 (August 2003).

<sup>105</sup> Devereux and Alan Auerbach, a participant in the Devereux Group, have published prior papers describing the tax. See, for example, Alan Auerbach, Center for American Progress, A Modern Corporate Tax (2010).

<sup>106</sup> The President's Advisory Panel on Federal Tax Reform (2005)

<sup>107</sup> Ways and Means Committee. A Better Way: Our Vision for a Confident America: Tax, June 24, 2016.

<sup>108</sup> The Advisory Panel report also described an origin-based cash flow tax. See Advisory Panel, note 106, at pp. \_\_\_\_\_

goods is a business and will only get a deduction where the seller is subject to tax in the same jurisdiction on its sale. That eliminates any incentives to locate functions and activities in tax-favored jurisdictions. It completely levels the playing field between resident and non-resident multinationals. The same issues as discussed above with respect to sales-based residual profit proposals exist under the DBCFT for remote sales to consumers (since they are not deducting their purchases), but these issues are no worse than under the alternative proposals.

One principal problem with the DBCFT proposal is that it is likely inconsistent with GATT agreements as interpreted by the WTO.<sup>109</sup> The deduction for domestic but not foreign wages attributable to imports is likely an impermissible discrimination against imports; similarly the deduction for wages attributable to exports can be viewed as an export subsidy. While arguments regarding WTO legality can be made, they may be difficult to sustain.

A second problem stems from the fact that the proposal eliminates any origin-based tax on business activities. If adopted unilaterally to replace the current business income tax, the proposal would make the adopting country one of the few jurisdictions in the world not imposing that kind of tax on business income; non-adopting countries would understandably view that country as a tax haven. Thus, while adopting a DBCFT as a partial replacement for a more traditional origin-based corporate income tax may well be an efficient way to allow for a substantial reduction in the rate of the origin-based tax, complete replacement of that tax with a DBCFT may not be feasible or sensible unless done on a multilateral basis.<sup>110</sup>

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<sup>109</sup> Wolfgang Schon, another participant in the Devereux group, has written extensively on this subject. See Wolfgang Schon, "Destination-Based Income Taxation and WTO Law" Max Plank Institute for Tax Law and Public Finance working paper 2016-03.

<sup>110</sup> Devereux and Auerbach argue that if one or more major countries – like the United States – adopt the tax as a replacement for its origin-based tax, it will force other countries to follow suit. See Auerbach and Devereux "Consumption and Cash-Flow Taxes in the International Setting" National Bureau of Economic Research working paper No. 19579 (Oct. 2013).

## Where Should We Go From Here?

**From a Tax Administration Perspective.** One conclusion readily drawn from the foregoing discussion of potential alternatives to the existing arm's length transfer pricing rules is that there are no easy fixes. It may well be that one or another of those alternatives could be an improvement over the existing approach. However, none of the alternatives would be easy to develop, easy to apply or problem free. All have their own complications and none (other than possibly the DBCFT) would easily banish transfer pricing controversy or put an end to tax planning.

Moreover, any attempt to discard the arm's length principle for another approach would involve heavy transaction costs. Current treaties require adherence to the arm's length principle and arguably would have to be abandoned or modified if another approach were to be adopted. A unilateral move by one or a few countries to a new approach would necessarily give rise to double taxation until such time as a global consensus could be reconstituted. But the challenge of finding a new global consensus would be daunting. The years of efforts on the CCCTB with no agreement, and the thirteen years to develop guidance on attribution of profits to permanent establishments under Article 7 with very little international agreement as to the ultimate outcome, both provide some warning as to what would be involved in resetting the standards in an increasingly complex global environment.

But standing still does not seem a particularly attractive option either. The BEPS transfer pricing rules are too complicated, too prone to controversy, and leave too many questions unanswered to allow countries to simply walk away and say the task has been accomplished. If the arm's length principle is to be retained, more effort will be required. That effort would need to focus urgently on the questions of clearer definitions regarding the returns

to funding activities and capital, clearer descriptions of how the normal cases where functions and risks are spread throughout the group can be dealt with, and importantly, how one can determine which entities bear the risks of actual returns departing from projected returns and how those differences can be allocated in the group. The very challenging questions raised in Action 1 of the BEPS Reports relating to the digital economy also cannot be ignored for long.

A further urgent need is to recognize that all of these new rules on returns to funding, allocation of risk, and attribution of ex ante and ex post differences cannot be addressed in every case. The questions are too hard for any but the most difficult cases and other, simplified approaches will have to be found to resolve more routine matters. The recent OECD work on safe harbours has largely been ignored by country tax administrations, but simplified, safe harbour approaches are going to have to be a large part of any stable solution to the transfer pricing problem.

**From a Broader U.S. Tax Reform Perspective.** Many in the United States have voiced concern over what is seen as the loss of revenues—and jobs—from the transfer price planning of U.S. multinationals.<sup>111</sup> Given the high U.S. corporate tax rate, and the continued availability of planning opportunities to move business activities and income to tax-favored jurisdictions, these concerns will continue post-BEPS and if anything could be heightened as multinationals migrate more functions and activities to align with income in those jurisdictions. Improvements to the transfer pricing rules will not alter this fundamental reality.

One solution proposed by some academics is to tax U.S. multinationals currently on their world-wide income, potentially at a rate lower than the full corporate tax rate.<sup>112</sup> That is

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<sup>111</sup> See, e.g. Edward Kleinbard, "The Lessons of Stateless Income" 65 Tax Law Review 99 (2011).

<sup>112</sup> See, e.g. Fleming, Peroni and Shay "Getting Serious About Curtailing Deferral on Foreign Source Income, 52 Southern Methodist University Law Review 2 (1999).

a very risky solution because the United States cannot similarly tax non-U.S. based multinationals; the resulting disparity of treatment risks a long-run migration of asset ownership that is unlikely to be in the United States interests.

To avoid this result, any solution should move in the direction of treating U.S. and non-U.S. multinationals similarly. The DBCFT clearly does that by being destination based. That is one of the principal reasons it appealed to Ways & Means Republicans—and should appeal to many Democrats as well. If, however, something less challenging to international tax norms is more desirable or feasible, the two residual profit proposals discussed above should be studied in more serious detail. Each would treat the residual profits of U.S. and non-U.S. multinationals similarly. And each could, subject to further study, substantially reduce the incentives to move functions and activities to tax-favored jurisdictions.

In the end, the need to consider these more far-reaching proposals further depends on the tax rate imposed by the United States under its current corporate tax compared to that of relevant alternative jurisdictions. In part because of BEPS, and increasingly because of pressures from the European Union, the ability of multinationals to achieve stateless income or even single digit effective tax rates is rapidly diminishing. We may well be moving to a world where paying an effective rate in the low to middle teens is the best tax planners can do. The question then is what tax rate will the U.S. be imposing. If, for example, by adopting some variant of a consumption tax, the United States could reduce its origin-based corporate tax rate to 20% or less, as some have proposed, a solution of working with OECD and other countries to improve the post-BEPs transfer pricing regime as described above makes eminent sense. But if U.S. corporate tax rates are to stay at or near current levels, the DBCFT residual profit allocation and residual profit apportionment proposals discussed above should be seriously considered.

Unfortunately, given the stalemate over U.S. business tax reform, it seems that the U.S. and OECD policy makers will be talking about transfer pricing and income attribution, and multinationals will be focusing on the movement of activities and functions, for some time to come.