OECD'S PROPOSED NEW APPROACH TO TRANSFER PRICING OF INTANGIBLES: A CRITIQUE

Student Author:
Elizabeth J. Stevens
New York University School of Law, LL.M. (Taxation) 2014
304 9th Street, NE, Washington, DC 20002
(619) 368-2090
EJern63630@gmail.com

Faculty Sponsor:
Mitchell Kane
New York University School of Law
40 Washington Square South, Suite 423, New York, NY 10012
(212) 992-8179
mitchell.kane@nyu.edu

I. Introduction

As part of its Base Erosion and Profits Shifting ("BEPS") Project, OECD has proposed a new approach to the taxation of related-party transactions involving intangibles.[1] If implemented by OECD member governments, this approach could achieve its goal of reducing multinational enterprises' ability to artificially shift to low-tax jurisdictions profits arising from their exploitation of intangibles. But achieving this end will not justify the means proposed to reach it. The arm's length standard, as articulated in Article 9 of the OECD Model Tax Convention, is the core principle of OECD transfer pricing.[2] The proposed new approach undermines this principle by requiring that taxable profits derived from intangibles be allocated according to a unitary analysis predicated on unsupported assumptions, rather than a separate-entities analysis based on evidence of how independent enterprises actually behave at arm's length. The BEPS Project proposals also meaningfully diverge from member states' domestic laws that have been designed around the arm's length standard. This incongruity will necessarily inhibit and could forestall the proposals' implementation. This would not be a bad result. Transfer pricing of intangibles does contribute to the problem of BEPS,[3] but this Paper claims that enforcement of existing standards—not adoption of new ones—is the appropriate solution.

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[1] *See* OECD Center for Tax Policy & Administration, *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (July 30, 2013) [hereinafter, *Revised Discussion Draft*]. The Revised Discussion Draft disseminated in summer 2013 drew upon prior OECD work folded into the BEPS Project after the project's launch. *See* OECD Center for Tax Policy & Administration, *Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* (June 6, 2012) [hereinafter, *Initial Draft*].

[2] *See* OECD Model Tax Convention on Income and Capital, art. 9(1), July 22, 2010 [hereinafter, Model Treaty].

[3] *See, e.g.,* Rosanne Altshuler & Harry Grubert, *Formulary Apportionment: Is it Better Than the Current System and Are There Alternatives?*, 63 NAT'L TAX J. 1145, 1146 (2010) (observing, based on data from prior studies, that MNEs' "shifting of income from intangible[] assets . . . to low tax countries is a major source of profitability differences across high and low tax countries")

Part II of this Paper lays the groundwork for these arguments. It first provides context for OECD's proposals by briefly summarizing current policy on the transfer pricing of intangibles and introducing the BEPS Project's objectives for change in that area. It then outlines aspects of the current proposals which reflect a conceptual shift away from the arm's length standard: their near-disregard for legal ownership of intangibles and contributions to the costs of their development as factors attracting a (taxable) share of income from those intangibles.

Parts III and IV present a critique. Part III asserts that OECD's proposals will in practice yield non-arm's length results because—at arm's length—both legal ownership and cost-bearing typically attract a share (at times a sizeable one) of the return from exploitation of an intangible. To support this argument, Part III draws upon examples derived from the author's personal experience and from public comments on the proposals. Part IV asserts that the proposed new approach is inconsistent with existing legal norms in OECD member states because the arm's length principle is deeply embedded in many OECD members' domestic laws, including with regard to the taxation of income from intangibles. It illustrates this argument with examples from the United States tax code.

Part V offers concluding observations. It assesses the proposed new approach to legal ownership and cost contribution as an outcome-oriented if not outcome-driven response to perceived abuses and to the resulting distribution of tax revenue. As long as OECD subscribes to the arm's length principle as "the sound theoretical basis" for transfer pricing, it should not adopt an alternative approach that it deems normatively unjustified, simply because countries are dissatisfied with how much tax is collected

where under the existing rule.[4] Tools to combat the perceived abuses already exist. The abuses' persistence reflects a lack of committed enforcement rather than a lack of OECD guidance.

II. OECD's Approach to Transfer Pricing of Intangibles

As explained above, this Paper claims that the new approach to transfer pricing of intangibles presented by the BEPS Project departs markedly from existing transfer pricing guidance. To support that argument, the Paper briefly describes and compares the new approach and corresponding content within the OECD Transfer Pricing Guidelines (the "Guidelines"). Section A outlines current OECD guidance on the transfer pricing of intangibles, which presently recognizes legal ownership and cost contribution as factors that draw a share of taxable return from intangibles. Section B introduces the BEPS Project's objectives and action item related to the transfer pricing of intangibles. Section B then turns to the two discussion drafts relevant to that action item: an initial draft released in June 2012 (the "Initial Draft"), and a revised version released in July 2013 (the "Revised Draft" and together with the Initial Draft, the "Drafts"). As Section B explains, the Drafts characterize legal ownership and cost contribution as insufficient to secure a share of the taxable income from an intangible, instead advocating a multinational group-wide allocation determined through a functional analysis.

A. Transfer Pricing of Intangibles: Where We Are

Any discussion of OECD's existing approach to the pricing of related-party transactions for tax purposes must begin with Article 9 of the OECD Model Tax

[4] *See* OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, ¶¶ 1.15, 1.21-1.31 (2010) [hereinafter, Guidelines].

Convention (the "Model Treaty"), which establishes the arm's length standard ("ALS") as the guiding principle for international transfer pricing among OECD member states:

> [Where] conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.[5]

By its terms, Article 9 requires a comparison. Before additional profits may be attributed to an associated enterprise, both the conditions of the related-party transaction and its results must be compared against those of a transaction between independent enterprises—that is, between parties operating at arm's length.

The Guidelines introduce ALS as "the international transfer pricing standard that . . . should be used for tax purposes" by multinational enterprises ("MNEs") and member states' tax authorities.[6] As articulated in the Guidelines, because transactions between related parties are not subject to normal market forces, transfer prices set in these transactions could distort the parties' tax liability (and countries' corresponding tax revenues).[7] To remedy this distortion, ALS seeks to ascertain, and then to impose, the transfer price that would have obtained had market forces operated normally.[8]

In applying ALS, the Guidelines direct taxpayers and tax administrators to identify the arm's length transfer price for a related-party transaction through analysis of

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[5] OECD, Model Treaty, *supra* note 2, art. 9(1); *see also id.* art. 9(2) (prescribing corresponding adjustment to the other enterprise's profits). OECD's application of the arm's length standard reflects its adoption of the "separate entity approach," whereby each juridical enterprise within a multinational group is treated, for tax purposes, as a separate, independent taxpayer. OECD, Guidelines, *supra* note 4, Preface ¶ 5. This approach is thought to reduce the risk of double taxation and inequitable results due to the heterogeneity of member states' tax systems. *Id.*

[6] OECD, Guidelines, *supra* note 4, ¶ 1.1.

[7] *See Id.* ¶ 1.3

[8] *See id.*

comparable uncontrolled transactions.[9] Comparable uncontrolled transactions are transactions between independent enterprises in which: (1) economically relevant characteristics—such as functions performed and risks borne by each party—are "sufficiently" comparable to the related-party transaction under examination; and (2) reasonably accurate adjustments can be made for any economically material differences.[10] The Guidelines prescribe a highly-detailed, holistic analysis of the transaction and associated enterprises under examination, and of any proposed comparables, to ensure the requisite degree of comparability.[11] With the partial exception of the transactional profit split methods,[12] the Guidelines' formula for applying ALS entails identifying and analyzing comparables, thereby tethering the result—the transfer price upon which the associated enterprises will be taxed—to market transactions.[13]

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[9] *See id.* ¶ 1.6 (comparability analysis "is at the heart of the application of the arm's length principle").

[10] *See id.* ¶¶ 1.33-1.36.

[11] *See id.* ¶¶ 1.33-1.63, 3.1-3.79.

[12] *See id.* ¶¶ 2.108-2.143. One could argue that the Transactional Net Margin Method ("TNMM") also represents a departure from pure ALS. *See, e.g.,* Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation* 19 (Univ. of Mich. Law & Economics Working Papers Archive 2003-2009, Art. 73, 1997), *available at* http://repository.law.umich.edu/law_econ_archive/art73 (describing the Comparable Profits Method, the U.S. equivalent of TNMM, as evidence of the decline of "the traditional ALS"). Because TNMM, like the Comparable Uncontrolled Price, Resale Price, and Cost-Plus methods, derives the arm's length transfer price from comparables data, I class them all together. Profit split methods, however, are typically applied where no acceptable comparables are available, and entail division of overall profit from the associated-enterprise transaction based upon a single or multivariable formula. *See* OECD, Guidelines, *supra* note 4, ¶¶ 2.118-2.123, 2.132-2.139. While profit split methods aim for "a reasonable approximation" of a market result, *see id.* ¶ 2.118, reasonableness is a matter of judgment, and perceptions of reasonableness may differ markedly not only between taxpayers and examiners, but also among member states' tax authorities. Notably, to the extent that OECD's grudging acceptance of profit split methods represents its first major deviation from ALS, this deviation occurred primarily due to the paucity of available comparables data for transactions involving intangibles. *See* I.R.S. Notice 88-123, 1988-2 C.B. 453. I recognize that the integration of profit split methods into the Guidelines poses challenges for my arguments. As this Paper's scope is limited, however—its purpose is to present a narrowly focused critique of current proposals—I will not address this past change to the Guidelines.

[13] *Cf.* Mitchell A. Kane, *Transfer Pricing, Integration and Novel Intangibles: A Consensus Approach to the Arm's Length Standard* 49-51 (Apr. 16, 2014) (unpublished manuscript) (on file with author) (arguing that, "[u]nder the best reading of what the arm's length standard is actually doing, it has

This guidance applies with equal force to transactions in which intangibles are transferred, whether through outright sale or under a license.[14] Chapter VI of the Guidelines, which addresses special considerations relevant to intangibles transfers, seems to take as given that an intangible's legal owner will necessarily garner a share of the return from its exploitation.[15] Allocation of income away from the owner to another party based upon the latter's value-adding functions performed represents the exception rather than the rule, and in such a case, the remedy lies in requiring arm's length compensation from the owner to the enhancing party, not in allocating a share of the intangible-related return to that party.[16] Further, where related parties collaborate in the joint development of an intangible, a participant may obtain rights constituting actual legal ownership—and accordingly, a claim on returns to the intangible—by contributing to development costs.[17] Providing funding, alone, can secure a share of returns to the intangible so long as the financing party's reasonably expected benefit is commensurate with its contribution, and the arrangement satisfies ALS.[18] Hence, in broad summary, the current Guidelines prescribe a transfer pricing analysis for intangibles that adheres to ALS and that, pursuant to this standard, recognizes legal ownership and cost

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nothing to do with such a correspondence to some independent economic reality" but instead "provides a *methodological* approach by which countries can seek to make adjustments in a way that (i) reaches a mutually acceptable non-overlapping allocation of the tax base and (ii) approaches, but does not replicate the result that would follow . . . where parties are not operating under common control").

[14] *See* OECD, Guidelines, *supra* note 4, at ¶ 6.13.

[15] *See id.* ¶¶ 6.3-6.4 (describing how ownership is determined in the context of contract research, and observing that some marketing intangibles may be legally owned and used only with the owner's permission).

[16] *See id.*, ¶ 6.38 (explaining that, at arm's length, whether a party other than an intangible's legal owner will receive "the future benefits of . . . activities that increase the value of that intangible will depend principally on the substance of the rights of that party"). *Cf.* Asociacion Espanola de Asesores Fiscales, *Comments to the OECD Discussion Draft on the special considerations for Intangibles in Transfer Pricing Guidelines* 4-5 (September 2012) (citing "the traditional and consolidated rule of allocation of income based on legal ownership or legal rights on the asset").

[17] *See* OECD, Guidelines, *supra* note 4, ¶ 8.6.

[18] *See id.* ¶¶ 8.13-8.16.

contribution, without more, as legitimate bases for allocating a share of the intangible-related return.

B. Transfer Pricing of Intangibles: Where We May Be Going

In February 2013, launching its BEPS Project, OECD issued a report quantifying the extent of base erosion and profits shifting by MNEs under the existing international tax regime and identifying "key pressure areas" within that regime, modifications to which would quash much MNE tax avoidance.[19] Among these key pressure areas was "[t]ransfer pricing, in particular in relation to the shifting of risks and intangibles, [and] the artificial splitting of ownership of assets between legal entities within a group."[20] In a subsequently issued Action Plan, OECD set itself the following tasks:

> Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.[21]

This action item does not authorize a departure from ALS due to any perceived susceptibility of intangibles transfers to tax avoidance. On the contrary, the Action Plan firmly rejects moving to a formulary apportionment standard,[22] under which a MNE's group-wide profits would be aggregated, and then allocated among its constituent members "based on some combination of costs, assets, payroll, and sales."[23]

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[19] *See* OECD, *Addressing Base Erosion and Profit Shifting* 10, 15-18 (2013) [hereinafter, *Addressing BEPS*].

[20] *Id.* at 48.

[21] OECD, *Action Plan on Base Erosion and Profit Shifting* 20 (2013) [hereinafter, *Action Plan*].

[22] *See id.* at 14.

[23] OECD, Guidelines, *supra* note 4, ¶ 1.17. The Guidelines acknowledge that ALS is an imperfect instrument, both theoretically and practically, *see id.* ¶¶ 1.10-1.13, but OECD has repeatedly rejected alternative standards in favor of continued adherence to ALS. *See, e.g., id.* ¶¶ 1.14-1.32; OECD, *Action Plan*, *supra* note 24, at 14.

Yet, moving incrementally—or perhaps not-so-incrementally—away from ALS and toward apportionment based on employees is precisely what the Drafts propose to do. The Initial Draft and the Revised Draft each present a wholly revised version of Chapter VI of the Guidelines. Some of the proposed changes—such as clarification of the status of location savings (a market feature, not an intangible)[24]—are for the better. This Paper considers one change for the worse: Although the Drafts profess continued loyalty to ALS,[25] they fundamentally diverge from it, in effect adopting formulary apportionment without a formula. This divergence occurs in three steps.

First, the Drafts import the emphasis on functions performed, risks borne, and assets used that forms the core of the comparability analysis into a new, threshold analysis.[26] As explained in Section A of this Part, current Chapter VI—in harmony with Article 9 and with the Guidelines as a whole—requires determination of an arm's length transfer price based upon market data derived from uncontrolled transactions in which the parties, *inter alia*, performed comparable functions, assumed comparable risks, and used comparable assets.[27] The Drafts introduce a "threshold inquiry": One must examine legal registrations and contractual arrangements for consistency with functions performed, assets used, and risks borne by members of the MNE "in developing, enhancing, maintaining and protecting" the intangible in question, in order to identify group members to which a share of the intangible-related return should be allocated.[28] In short, functions, assets, and risks would now determine not only *how much* profit would be allocated, but also *among whom*.

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[24] *See* OECD, *Revised Draft*, *supra* note 1, ¶¶ 1-5.
[25] *See* OECD, *Initial Draft*, *supra* note 1, ¶ 1; OECD, *Revised Draft*, *supra* note 1, ¶ 35.
[26] *See* OECD, *Initial Draft*, *supra* note 1, ¶¶ 27, 29; OECD, *Revised Draft*, *supra* note 1, ¶¶ 65-66.
[27] *See supra* pp. 3-7.
[28] *See* OECD, *Initial Draft*, *supra* note 1, ¶¶ 27, 29.

Second, the Revised Draft asserts that each of the MNE members identified in the threshold analysis should be allocated "all or part of the return attributable to the intangible."[29] As the Revised Draft observes, ALS requires that group members receive arm's length "compensation for any functions they perform, assets they use, and risks they assume in connection with" the development and/or exploitation of an intangible, regardless of which group member is the intangible's legal owner.[30] The Revised Draft equates this compensation with an allocation of the intangible-related return in accordance with group members' relative contributions of functions, assets, and risks.[31] But, while the difference may be a subtle one, allocating the intangible-related return among MNE members, on the one hand, and subjecting each transaction (real or imputed) to a comparability analysis under ALS, on the other, are not identical exercises. The Revised Draft's language implies that the former would entail a holistic analysis, in which all group members' contributions are contemporaneously weighed and compared against one another[32]—a unitary approach. The latter considers each transaction separately, as would occur if the legal owner had contracted with a variety of independent enterprises to fill the roles played by its affiliates in the transaction under examination, and compares members' contributions to those of parties in uncontrolled transactions.

One might contend that these approaches represent simply two routes to the same destination given that both ultimately seek to allocate taxable income in

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[29] *See* OECD, *Revised Draft*, *supra* note 1, ¶ 65.

[30] *See id.* ¶ 74.

[31] *See id.*

[32] *See id.* ¶ 65. *Cf.* Deloitte LLP, *Comments on the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* 16-17 (September 29, 2013) (alleging that the Revised Draft effectively defaults to recharacterization on substance-over-form grounds by conflating multiple intangible-related transactions).

accordance with functions, assets, and risks. But initial income allocations can, and likely will, influence the transfer pricing inquiry's result. MNEs engage in related-party transactions because doing so reduces transactional costs, thus generating additional profit beyond that realized in comparable transactions between unrelated parties.[33] Consequently, reference to independent-party transactions will not compel reallocation of this residual profit away from the party to which it is initially assigned. Under current Chapter VI, that party is the intangible's legal owner. The Drafts' holistic approach, under which income from the transaction is divvied up among the MNE's constituent entities in the first instance, would allocate shares of residual profit to multiple parties.

Third and finally, the Initial Draft adopts the position that "neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity . . . to retain the benefits or returns with respect to intangibles without more."[34] Instead, the Revised Draft explains, a legal owner must "generally perform, through its own employees, the most important functions related to the development, enhancement, maintenance, and protection of that intangible."[35] That is, employees of the legal owner must exercise control over strategic decisions, budgets, and program

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[33] *See* Reuven S. Avi-Yonah, Kimberly A. Clausing, & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 501 (2009).

[34] *See* OECD, *Initial Draft*, *supra* note 1, at 12; *see also* OECD, *Revised Draft*, *supra* note 1, ¶¶ 73, 82, 84. *But see* Barsalou Lawson, *Comments on the Discussion Draft Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* 4 (September 14, 2012) (criticizing the Initial Draft's unqualified statement as unjustified by its premises, and insisting that "[t]his particular question can only be answered through an analysis of third-party comparable transactions"); Deloitte LLP, *Comments on the OECD Discussion Draft on Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* 2 (September 13, 2012) (pointing out that, while the Initial Draft "cautions against making unsupported assertions," its own unsupported assertion reflects a "potentially significant departure[] from evidence-based applications of the arm's length principle").

[35] *See* OECD, *Revised Draft*, *supra* note 1, ¶ 80. *But see* Deloitte LLP, *supra* note 32, at 17-18 (criticizing the Drafts' "sweeping statement[s]" with respect to legal ownership as creating risks of misinterpretation, failing to take into account comparable uncontrolled transactions, and ignoring the legal owner's assets and risks).

design with respect to the generation of an intangible's value, as well as over any functions performed by other entities that may materially affect that value.[36] This language implies that assets supplied and risks borne are at least secondary to functions performed, if not entirely irrelevant, in determining whether the legal owner is entitled to retain a share of the return on its intangible. The Revised Draft relents slightly with respect to cost contribution: Alone, it will generally entitle the financing party "to a risk-adjusted rate of anticipated return on its capital invested, but not more."[37] Why "not more"? Because, the Revised Draft insists, "in arm's length transactions, a party that provides funding but does not control the risks or perform other functions associated with the funded activity, generally [will] not receive returns equivalent to those received by an otherwise similarly-situated investor" who does engage in these additional activities.[38] The Revised Draft does, admittedly, make reference to ALS and to comparability. But it also makes unqualified statements regarding legal ownership and cost contribution which apparently govern notwithstanding any contrary uncontrolled comparables.

In sum, the Drafts prescribe a new approach in which *all* parties performing functions, bearing risks, or supplying assets that contribute to an intangible's value are to be allocated a share of the return from that intangible commensurate with their

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[36] *See* OECD, *Revised Draft*, *supra* note 1, ¶ 79.

[37] *See id.* ¶ 84. One might be inclined to view the functions, assets, and risks-based allocative approach as designed to bolster the right of source country distributor or sales subsidiaries whose expenditures advance the parent's brand value, to a share of the brand-related returns. Cost contribution receives short shrift under the Drafts, however, so to stake a claim to (taxable) profits, these subsidiaries would also have to bear brand-related risks and add brand value through (non-financial) activities, such as designing marketing campaigns.

[38] *See id.* ¶ 82. Although the Revised Draft retreats from the Initial Draft's position on cost contribution, at least one commentator supports the original, bold formulation. *See* Michael C. Durst, *The OECD's Discussion Draft on Transfer Pricing for Intangibles*, 136 TAX NOTES 315, 317 (July 16, 2012) (characterizing the Initial Draft's statement as "an important . . . clarification of the arm's-length principle" and insisting that it "is and has always been flatly incorrect" that "bearing the financial costs of business activities entitles a party, for tax purposes, to income derived from those activities").

contributions,[39] but with the specific limitations that, alone, legal ownership draws no return, and cost contribution procures no remuneration beyond an arm's length risk-adjusted interest rate.

III. Inconsistency with Arm's Length Transactions

Part II concluded that the Drafts' proposals evince a conceptual shift away from ALS. The Guidelines have long emphasized functions, assets, and risks as essential components of the comparability analysis employed to determine how much profit will be allocated to related parties in a transaction. The Drafts repurpose these characteristics as determinants of *to whom*, as a threshold matter, returns to an intangible should be allocated. Neither the intangible's legal owner nor a party that finances the intangible's development will necessarily garner a share. If, as the Drafts seem to presume, the end result of this modified transfer pricing inquiry will still accord with ALS, the Drafts' proposals will affect only how one reaches that result. Yet, as this Part III argues, relying in part on the public comments received by OECD, [40] the Drafts'

[39] Commentators have recognized similarities between this proposed new approach to the pricing of transactions between a parent company and its foreign subsidiaries to OECD's authorized approach to the allocation of income between a parent company's home country operations and those of its foreign branches. *See, e.g.*, Lee A. Sheppard, *News Analysis: BEPS Implementation Anticipated*, TAX NOTES TODAY, March 3, 2014 ("The OECD is fond of nose counts, as the disastrous authorized approach to Article 7 profit attribution to permanent establishments demonstrated. So the BEPS plan says that IP income should be allocated according to a functional analysis, which is mostly about where the people are."); International Tax Center Leiden, Comments to the *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* 4 (October 1, 2013) (The emphasis of the paragraphs "defining ownership of intangibles (or entitlement to intangible-related returns) . . . is on 'functional control,' and the language appears to allude to an interpretation of the term 'ownership / entitlement' very much following the Authorized OECD Approach on Attribution of Profits to Permanent Establishments.")

[40] A word on the comments: Many of the organizations submitting comments on OECD proposals have business and financial interests at stake in the BEPS Project. MNEs and the service professionals and industry groups that advise and represent them—all parties directly or indirectly benefiting under the status quo—might reasonably be expected to exhibit some bias against meaningful change. Tax professionals and trade groups are, however, also well-placed to speak to whether the Drafts' proposals align with arrangements between independent enterprises encountered in the market. These independent companies are their clients or members, too. For that reason, I consider their testimony credible as to what actually happens at arm's length. I have endeavored to incorporate perspectives from non-US sources to present a more comprehensive picture.

approach will produce results at odds with arm's length transactions observable in the real world.[41]

A. Legal Ownership at Arm's Length

The Drafts would allocate taxable income away from an intangible's legal owner where the owner has not, through its own employees, performed or exercised "control" over certain essential functions with respect to the intangible. Despite its granular detail in other respects, the Revised Draft does not make clear what level of supervision will satisfy this retained "people functions" requirement. Anecdotal evidence suggests that, at arm's length, a legal owner may afford considerable autonomy to contract service providers without surrendering the full (or any) return on its intangible.

"[O]utsourcing is a common way to do business between independent enterprises . . . ."[42] While practice varies by industry, "once the outsourcing contract is concluded and the terms and conditions agreed (including price), it is frequent for the sub-contractor to operate without control by the principal over its day-to-day activities."[43] Even where a principal gives up functional control, it may still obtain legal ownership at arm's length by virtue of its contribution of assets and bearing of risks.[44] Whether and to what extent the principal continues to exercise control over outsourced activities involving intangibles will likewise vary with practice. One commenter assured that "the principal retains the full control and risk of the project" (though what such "full control"

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[41] Michael Durst—previously a director of the United States' Internal Revenue Service's Advance Pricing Agreement Program—has written approvingly of the Drafts' approach to legal ownership and cost contribution, but even he counsels that OECD should "perform empirical research concerning contracting patterns employed by unrelated parties acting at arm's length if its guidelines are to effectively conform to the arm's-length principle." Durst, *supra* note 38, at 319.

[42] Association Française des Femmes Fiscalistes, *Comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* 8 (Sept. 30, 2013).

[43] *Id.*

[44] *See* Deloitte LLP, *supra* note 32, at 18.

means is no less ambiguous than "control," itself).[45] Another relayed its "experience . . . that many arm's length situations exist where a party that commissions, pays for and ultimately owns the intellectual property resulting from research does not retain most, or occasionally any, of these functions to be performed by its own employees."[46]

Leaving aside the extent of the principal's control over outsourced activities, how are contract service providers compensated? "[A]rm's length compensation can be structured either as (i) a payment in full at the time that the activity is carried out or (ii) an equivalent claim (taking timing and risk into account) on expected future profits, but not both."[47] Although, at arm's length, a company might contract with a highly skilled service provider to develop an intangible, it would not necessarily agree to share the ultimate value of the intangible with the developer.[48] "[C]ontract researchers do not necessarily share in the return from the outcome of the research, unless they also share in the risk of the research process itself."[49] Yet, while the forgoing comments reflect a majority view, at least one commenter speculated that an unrelated contract developer would demand a share of the return from any intellectual property it produced pursuant to the contract:

> For a high-end contract R&D service provider, which has the sophistication required to develop potentially highly valuable intellectual property, to agree to do so for only fixed compensation would place the

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[45] *See id.*

[46] Deloitte LLP, *supra* note 34, at 17.

[47] KPMG International, *OECD Invitation to Comment on the 'Revised Discussion Draft on Transfer Pricing Aspects of Intangibles"* *8 (Sept. 28, 2013).

[48] *Id.* One commenter, citing clients' recent experiences with contracting out development of smartphone applications to unrelated parties, offered a hypothetical in which the contracting party would own the resulting intangible despite the contractor's having "performed the key development, enhancement and maintenance functions for the App." BDO, *Comments on the Chapter VI Discussion Draft* 5 (Sept. 6, 2012).

[49] Baker & McKenzie Global Transfer Pricing Group and Global Tax Policy Initiative, *Comments on the OECD Discussion Draft on the Proposed Revision of Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* 24 (Sept. 17, 2012).

> R&D provider at great economic risk. That R&D provider probably will demand a share in future income from developed intangibles as part of the compensation under its contracts. Indeed, it seems unlikely that for intangibles of potentially high value, contracts in which the party purchasing R&D services receives full residual rights to developed intangibles exist at arm's length.[50]

Where the outsourced activity consists of enhancing an existing intangible rather than developing one from scratch, "[a]dvertising agencies rarely share in the return from the trademark which they are contributing to enhancing," and where an independent party contributes to process or product improvements, such a contribution does not "systematically lead to a co-ownership of the intangible concerned" and a "share in the intangible return."[51] Rather, as another commentator lucidly observed, in uncontrolled transactions, "the economics . . . will be, at best, only one of the factors taken into account in determining who has the right to enjoy the profit arising from an intangible," and "factors such as the statute dealing with the intangible, registrations held and contracts entered into" often carry greater weight.[52]

At arm's length, then, legal ownership appears to matter—and to command a significant share of the intangible-related return. This conclusion holds for outsourcing arrangements, in which the legal owner does not develop, enhance, maintain, or protect the intangible through its own employees. Whether the legal owner would nevertheless satisfy the (ambiguous) "control" requirement imposed by the Drafts is uncertain. Even if the Drafts' functional approach happens to produce results consistent with arm's

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[50] Durst, *supra* note 38, at 318.

[51] Baker & McKenzie Global Transfer Pricing Group and Global Tax Policy Initiative, *supra* note 49, at 24, 26; *see also* Deloitte LLP, *supra* note 34, at 10 ("the quantum of remuneration provided by one party to another in respect of services rendered in developing intangible property is irrelevant in ascertaining the ownership of any intangible property created in many, if not most commercial transactions between unrelated parties").

[52] Deloitte LLP, *supra* note 34, at 15.

length behavior today, commercial behavior continually evolves.[53] The Drafts propose a fixed standard—legal ownership, alone, commands none of the intangible-related return—but the market is dynamic. Creating a stand-alone rule that holds regardless of any comparables analysis effectively ensures that, in some cases, application of this rule will impose non-market conditions on a related-party transaction.

B. Cost Contribution at Arm's Length

Unlike legal ownership, contribution to the cost of an intangible's development, enhancement, maintenance or protection can, alone, create an entitlement to a share of the intangible-related return under the Drafts' proposed approach.[54] But that entitlement is strictly limited: The party providing funding should be allocated "a risk-adjusted rate of anticipated return on its capital invested, but not more."[55] The Revised Draft insists that such a circumscribed return aligns with ALS.[56] While it may be true that cost-bearing does "not create an entitlement to *all* the intangible related return," it can and often does "create *an* entitlement to intangible related return" in arm's length transactions.[57] Commenters identified several examples at different stages in a business's life cycle:

Start-Up Formation. Contributions of money, property, or services "form the basis of relative ownership interests in the formation of a startup company, a partnership, a joint venture or a similar enterprise consisting of multiple

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[53] *See* Barsalou Lawson, *supra* note 34, at 6-7 (Sept. 13, 2012) (citing "'non-practicing entities' . . . and defensive patent aggregators"—also known as "patent trolls"—as examples of newly evolved business forms in which legal ownership of an intangible is largely divorced from value creation).

[54] *See* OECD, *Revised Draft*, *supra* note 1, ¶ 84.

[55] S*ee id.*

[56] S*ee id.* ¶ 82.

[57] *See* Baker & McKenzie Global Transfer Pricing Group and Global Tax Policy Initiative, *supra* note 49, at 25.

owner/participants."[58] In advising clients on the formation of such enterprises, this author has observed that the participants typically negotiate at arm's length regarding the economic arrangement that will govern the venture. A participant providing funding, but nothing more, may secure a significant share of profits—surprisingly often, a share greater than or equal to that of the participant who supplies the business concept and plan and who will work in the venture. That often-disproportionate share will embrace the returns to any valuable intangibles created in the business. Holders of such "passive equity interest[s]" incur limited financial risks (if investing in a limited liability vehicle) but nevertheless have a claim to "residual profits . . . from business assets or activities."[59] At the start-up stage, at arm's length, the superior negotiating position of the party supplying the cash will typically secure it a share of any intangible-related return.

Venture Capital or Private Equity Investment. As a business reaches adolescence, or even in mid-life, an unrelated party willing to provide financing may still wield outsized bargaining power that will enable it—at arm's length—to claim a significant stake in intangible-related returns. Cash, alone, can be enough. "Venture capitalist firms provide financial capital to high-risk businesses (essentially investing in their potential intangibles and management) in return for the ability to profit from those businesses' value through an ownership stake or other mechanism often without

[58] Patrick Breslin, *Comments on The Discussion Draft on Chapter VI of the OECD Transfer Pricing Guidelines* 10 (Sept. 14, 2012).

[59] *See id.* at 12 (citing the corporate shareholder as an archetype of passive ownership and contrasting a shareholder's characteristics with those of the party entitled to an intangible-related return under the Initial Draft).

performing the related activities or controlling key decisions."[60] Relatedly, "private equity, real estate investments, securitization vehicles, [and] hedge funds are all investment and industry sectors" in which "the return on the business activity is essentially allocated to investors taking a control decision role in the management of the business rather than a direct performance one."[61]

Contract Manufacture or Services. When a company matures, roles may reverse, and the company may command the lion's share of intangible returns solely by virtue of having provided funding to a third-party developer. As one commenter advises, "[M]any circumstances exist at arm's length in which third parties that finance intangibles development are provided with substantial returns if those efforts are successful."[62] For example, "[i]n the electronic consumer and industrial products industries, many electronics manufacturing services companies offer design services and run the majority of the design effort," and "[i]n the software industry, it is not uncommon for software development to be outsourced for a service fee."[63] In both cases, the party commissioning and paying for the work "continue[s] to earn intangible-related returns."[64]

Thus, as with the Drafts' position on legal ownership, their position on cost contribution does not accord with what reportedly occurs in arrangements between uncontrolled parties transacting at arm's length. Based on this anecdotal evidence, the Drafts' proposals would impose non-arm's length results on related-party transactions.

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[60] Ceteris, *Comments on the Proposed Revision of the Section on Safe Harbors in Chapter IV of the OECD Transfer Pricing Guidelines from Mark Bronson, Ceteris; Michelle Johnson, Ceteris; Simon Webber, Ceteris* 4 (Sept. 25, 2012); *see also* International Tax Center Leiden, *supra* note 39, at 4.

[61] Crowe Horwath, *Comments on the OECD Intangibles Draft of June 6, 2012* 2 (Sept. 14, 2012).

[62] Ceteris, *supra* note 60, at 4.

[63] *See id.*

[64] *Id.*

IV. Inconsistency with Internal Laws

Parts II and III argued that the Drafts' proposals—specifically with respect to the treatment of legal ownership and cost contribution—diverge from ALS both conceptually and in practice. One could take the position, however, that ALS has proven inadequate to the task of pricing related-party intangibles transfers, and that these transfers merit a distinct standard. But even if one dismisses the concerns expressed in Parts II and III, ALS cannot be so easily cast aside in favor of a functional approach. Each OECD member state "has its own tax, commercial and intellectual property law."[65] The Guidelines cannot be expected "to take[] into account all domestic legal aspects," but at the same time, the economic principles given primacy in the Drafts' functional approach "may only work within the parameters of the law."[66] This Part IV argues that the proposed new approach poses significant implementation challenges due to the extent to which ALS pervades or integrates with OECD members' internal laws, extending to areas beyond transfer pricing.

Internal law in most, if not all, OECD member states largely aligns with ALS. Article 9 appears in many tax treaties between OECD member states,[67] and most member states' internal transfer pricing rules follow ALS.[68] Some member states—the

[65] Barsalou Lawson, *supra* note 34, at 3.

[66] *Id.*; *see also* Scott Wilkie, *Comments on the OECD Intangibles Project* 5 (Sept. 30, 2012) ("[I]f the guidance in this area is ultimately intended to serve the intended objective . . . it is essential to evaluate and determine whether and to what extent the guidance offered in the Discussion Draft would be accommodated by OECD Members' tax and private law.").

[67] *See* Angharad Miller & Lynne Oates, PRINCIPLES OF INTERNATIONAL TAXATION § 7.13 (3d ed. 2012).

[68] The European Commission's Joint Transfer Pricing Forum has produced transfer pricing profiles for 26 European Union member states, 19 of which are also OECD members: Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden and the United Kingdom. According to these profiles, all 19 follow ALS. The profiles are available at: http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/#tpprofiles. The

United Kingdom, for example—have imported the Guidelines' content into domestic law.[69] To state the obvious, any proposed, substantive change to OECD transfer pricing's alignment with ALS will be a dead letter absent genuine buy-in from OECD member governments.

As may be less obvious, a shift away from ALS in the transfer pricing context may provoke conflict with, or necessitate changes to, other elements of OECD members' domestic tax laws. U.S. rules for taxing income from intangibles rely on ALS and thus illustrate this potential conflict.

ALS's pervasive influence in U.S. law extends beyond the transfer pricing realm. For example, where a U.S. person transfers certain intangible property to a foreign corporation in an exchange that would otherwise qualify for tax-free treatment, the transfer will, for tax purposes, be treated as a sale, with the imputed consideration taking the form of a royalty stream contingent on the intangible's productivity, use or disposition, and commensurate with the income attributable to it.[70] This allocation of imputed consideration away from the transferee-legal owner must be "consistent with the arm's length standard" and based upon analysis of uncontrolled comparables.[71]

ALS also anchors U.S. transfer pricing rules for wholly domestic intangibles transfers. When a taxpayer's performance of personal services results in the creation of intangible property, the property is a non-capital asset while held by its creator, since

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United States and Australia likewise follow ALS. *See* Reg. § 1.482-1(b)(1); *Income Tax Assessment Act 1936* (Cth) s 136AD (Austl.).

[69] *See* Taxation (International and Other Provisions) Act, 2010, c. 2, § 136 (U.K.).

[70] *See* I.R.C. § 367(d). The U.S. transferor retains tax liability for these deemed royalties notwithstanding transfer of the transferee's stock (received in the original exchange) to a related person (if the related person is a U.S. person, the liability shifts) or transfer of the intangible by the foreign transferee to another related person. *See* Reg. § 1.367(d)-1T(d)-(f).

[71] *See* Reg. § 1.367(d)-1T(c).

income from the intangible represents a return to the taxpayer's personal efforts.[72] If the creator assigns (with or without consideration) the intangible to another person, however, the transfer untethers it from the creator's personal services.[73] "[S]elf-created property rights . . . are effectively assignable for tax purposes despite the element of personal services on the part of the assignor."[74] Hence, as a general proposition, taxable income from intangible property follows ownership of the property.

But income does not strictly follow ownership when the parties are related: "In the case of any transfer (or license) of intangible property . . . the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."[75] Absent satisfaction of one of several safe harbors, U.S. revenue authorities will impose periodic adjustments to the royalty rate—or convert a lump sum

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[72] *See* I.R.C. §§ 61(a)(1), 1221(a)(3)(A).

[73] *See* Charles S. Lyon & James S. Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293, 374-79 (1962) (assessing and summarizing the then-current state of the law with respect to income from self-created intangibles); *see also* I.R.C. § 1235 (sale or exchange of all substantial rights associated with a patent is a sale or exchange of a capital asset).

[74] Martin A. Chirelstein & Lawrence Zelenak, FEDERAL INCOME TAXATION 256-57 (12th ed. 2012). This rule represents an exception to the general principle that, when a taxpayer has performed services and expects to receive compensation therefor, the taxpayer may not avoid tax on the income by assigning or otherwise transferring it to another before it is received. *See* Harrison v. Schaffner, 312 U.S. 579, 582 (1941) ("[O]ne vested with the right to receive income [does] not escape the tax by any kind of anticipatory arrangement, however skillfully devised, by which he procures payment of it to another . . . ."); *see also* United States v. Basye, 410 U.S. 441, 450-51 (1973); Helvering v. Eubank, 311 U.S. 122 (1940); Lucas v. Earl, 281 U.S. 111 (1930). Authorities establishing this exception distinguish between the assignment of income from self-created property, which remains taxable to the assignor-creator, and the assignment of the property itself, future income from which will be taxable to the assignee. *See, e.g.*, Heim v. Fitzpatrick, 262 F.2d 887, 889-90 (2d Cir. 1958) (where inventor had assigned his patent to a corporation owned by his family under a royalty contract, his subsequent assignment of all rights in that contract to family members was a transfer of a property right, and the royalties were not thereafter taxable to him); Comm'r v. Reece, 233 F.2d 30, 33-35 (1st Cir. 1956) (where inventor sold his patent rights to a corporation, he "received in substitution a new kind of property interest . . . a contract right to receive 'royalty' payments in future" of which he could wholly divest himself, for tax purposes, through an absolute assignment to his wife); Rev. Rul. 54-599, 1954-2 C.B. 52 (where taxpayer transfers and divests himself of all interest in the dramatization rights to his novel, "[a]ny income from such dramatization rights would be taxable to the [transferee]"); Rev. Rul. 54-409, 1954-2 C.B. 174 (a copyright may be divided into separate property rights, and the transfer of one such right for the life of the copyright constitutes a transfer of property, not a license).

[75] I.R.C. § 482.

into a royalty stream—based upon the returns realized by the related transferee.[76] Thus, where legal ownership of an intangible is transferred, a share of the return from that intangible may rest indefinitely with the transferor by virtue of its past contributions to value. Yet, even in this case, the transferee's initial entitlement to returns from the intangible, as its legal owner, is presumptive, not conditioned on the transferee's performance of value-adding functions. And any allocation away from the legal owner must accord with ALS.[77]

The Discussion Drafts' approach essentially reverses the parties' roles. The transferor's past contributions to value will necessarily garner an allocation of taxable income from the intangible post-transfer, whereas for the transferee, legal ownership, without more, draws no share of the intangible-related return. For the reasons explained in Part II, initial allocations matter. Hence, the Discussion Drafts' analytical approach will likely yield a different result from that dictated by U.S. internal transfer pricing rules. For the United States, then, adopting the Drafts' approach would entail modifications to internal law[78] as well as potential renegotiation of a vast network of bilateral tax treaties.[79] Many other OECD members would also be obliged to amend

[76] *See* Reg. § 1.482-4(f)(2).

[77] *See id.*

[78] Such modifications could be compelled by treaties' non-discrimination provisions, and leaving the existing regime in place—such that wholly-internal and cross-border intangibles transfers faced different sets of rules—would likely create arbitrage opportunities.

[79] The United States is a party to over 60 bilateral tax treaties. *See, e.g.* I.R.S., *United States Income Tax Treaties – A to Z*, *available at* http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z (last visited Apr. 17, 2014).

their internal laws.[80] And of course, bilateral treaties based on the Model Treaty would require reexamination to assure consistency with the new approach.[81]

Implementing any fundamental tax policy change on a multilateral basis will necessarily take time and effort. But given that the arm's length principle is so firmly and widely entrenched in OECD member states' laws and the global tax treaty network, only highly-convincing normative and functional arguments in favor of an alternative would justify a change. Notwithstanding the BEPS Project's ambitious scope, OECD has yet to make those arguments.

V. Concluding Observations

OECD launched the BEPS Project principally due to the "increased segregation between where actual business activities and investment take place and the location where profits are reported for tax purposes."[82] At least some of this segregation stems from the shifting of high-value, highly-mobile intangible assets to holding companies in low-tax jurisdictions.[83] On this basis, one could conclude that ALS just doesn't work for intangibles transactions. Perhaps the Drafts' authors have sided with the critics of ALS and believe that these transactions, at least, warrant a different set of rules.[84] The substance of their proposals implies as much.

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[80] *See supra* notes 68-69 and accompanying text.

[81] Other than those to which the United States is a party, "[n]early all treaties are based on the OECD Model." Miller & Oates, *supra* note 67, § 7.13. Treaties modeled on the OECD Model Treaty numbered 225 as of 1994. *Id.*

[82] *See* OECD, *Addressing BEPS*, *supra* note 19, at 20.

[83] *See* Altshuler & Gruber, *supra* note 3, at 1146; OECD, *Addressing BEPS*, *supra* note 19, at 42.

[84] Criticism of ALS abounds. As a theoretical matter, it "ignores the fact that multinational groups of companies arise precisely in order to avoid the inefficiencies that arise when unrelated companies must transact with one another at arm's length." Avi-Yonah, et al., *supra* note 33, at 501. And as a practical matter, it rests on the questionable "belief that transactions among unrelated parties can be found that are sufficiently comparable to transactions among members of multinational groups that they can be used as meaningful benchmarks for tax compliance and enforcement." *Id.* at 503; *see also* I.R.S. Notice 88-123, 1988-2 C.B. 453, 453, 466-468 (acknowledging the particular difficulty of finding reliable comparables for intangibles transactions and reviewing evidence of the same).

But if that is so, then OECD should not continue to profess allegiance to ALS while incrementally adopting formulary apportionment by stealth. OECD operates in the multilateral sphere, and with respect to taxation, its member states' revenue objectives will often be at odds with one another. Article 9 embodies those states' agreement that ALS is, normatively, the "right" way to go about pricing related-party transactions for tax purposes, taking into account that its application will at times advance and at others hinder their respective revenue goals. By retaining ALS for transfers of tangible goods and services, while quietly shifting to a non-ALS methodology for intangibles transfers, OECD risks reducing the Guidelines to a conceptual muddle and endangering a hard-won consensus. If OECD now believes that non-arm's length transfer pricing should be used in certain circumstances, it should articulate a normative justification for the change.

That a different tax rule would generate more revenue should not suffice. This Paper reads the Drafts' proposed functional approach as motivated by concern about, and a desire to target, specific types of transactions.[85] Wealthy countries, where most research and development contributing to high-yield intangibles occurs, are frustrated that their multinationals have managed to shift returns to pharmaceutical patents, software, and technology trademarks to tax-haven affiliates, principally through cost-

[85] More than one commenter agreed. *See, e.g.*, Baker & McKenzie Global Transfer Pricing Group and Global Tax Policy Initiative, *supra* note 49, at 4 ("We think that the direction of the Discussion Draft is largely influenced by concerns expressed by some OECD countries in relation to intangibles migrations and base erosion."); CMS Bureau Francis Lefebvre, *Reply to the OECD's Request for Comments on the "Discussion Draft – Revision of the Special Considerations for Intangibles in Chapter VI of the OECD TP Guidelines and Related Provisions – 6 June to 14 September 2012"* 9 (undated) ("In many cases, the current wording of the Discussion Draft therefore sounds, to some extent, as if had been designed to bar abusive schemes from being implemented, rather than to help good-faith taxpayers in implementing an appropriate, practical and efficient analysis and documentation based on a set of standards applicable to normal situations.")

sharing agreements.[86] European countries, moreover, have grown restive over the minimal source-country taxes paid by U.S. technology companies despite highly-visible economic activity within their borders.[87] But redrafting the OECD Transfer Pricing Guidelines to target perceived abusive practices is neither an efficient nor a sensible solution—for at least three reasons.

First, as a matter of principled system design and to facilitate practical implementation, outlier transactions should not dictate the content of generally-applicable tax rules. Bad facts, as the maxim goes, make bad law.[88] ALS may pose application challenges in the intangibles context, but the Drafts' proposed functional approach will only exacerbate these problems due to its inherent subjectivity. For an intangible's legal owner to retain any share of the intangible-related return, it must "control" through its own employees the functions "important" to creating and maintaining the intangible's value.[89] Whether a legal owner's level of engagement rises to "control," and which functions are "important" under the facts-and-circumstances-

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[86] *See, e.g.*, *Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.): Hearing Before the S. Permanent Subcomm. on Investigations*, 113th Cong. (2013) (opening statement of Senator Carl Levin), *available at* http://www.levin.senate.gov/newsroom/speeches/speech/opening-statement-of-sen-carl-levin-offshore-profit-shifting-and-the-us-tax-code-part-2-apple-inc; *Offshore Profit Shifting and the U.S. Tax Code): Hearing Before the S. Permanent Subcomm. on Investigations*, 112th Cong. (2012) (opening statement of Senator Carl Levin), *available at* http://www.levin.senate.gov/newsroom/speeches/speech/opening-statement-at-psi-hearing-offshore-profit-shifting-and-the-us-tax-code.

[87] *See, e.g.*, SELECT COMMITTEE OF PUBLIC ACCOUNTS, TAX AVOIDANCE-GOOGLE, 2013-14, H.C. 112 (U.K.) (summarizing evidence regarding activities of Google, Inc. affiliates within the United Kingdom, including facts tending to undermine Google's claim that it lacks a permanent establishment there, and structures created by Google to facilitate booking profits from non-U.S. advertising sales in Ireland); Lee A. Sheppard, *BEPS Progress Report*, 142 TAX NOTES 1154, 1155 (Mar. 17, 2014) (characterizing the BEPS Project as "a European project" involving "EU governments beating up on U.S. multinationals at a time when their budgets are severely strained in the wake of the financial meltdown caused by the United States and the ensuing sovereign debt crisis"); Sheppard, *supra* note 39, at 1 (explaining that, in the European view, "the right of the residence country to tax corporations has to be exercised . . . or forfeited," and describing the BEPS Project as "a giant throwback rule—if you don't tax it, we will").

[88] *Cf.* Northern Sec. Co. v. United States, 193 U.S. 197, 400 (1904) (Holmes, J., dissenting) ("Great cases, like hard cases, make bad law.").

[89] OECD, *Revised Draft*, *supra* note 1, ¶¶ 78-80.

dependent test the Revised Draft prescribes,[90] will not prove susceptible of objective answers in all cases. Indeed, "generally the tax authorities of the several countries involved would undertake a different or asymmetric approach to such issue[s]."[91]

Respecting an intangible's legal ownership may create the potential for abuse, but given the centrality of legal ownership to the law generally, removing this fixed criterion from the transfer pricing analysis—without replacing it with an alternative, objective standard—can only provoke increased double taxation. The Guidelines aim to present a common set of principles that countries may apply, thereby achieving greater complementarity with respect to taxation of cross-border transactions and hence reduced double taxation. Existing legal norms should accordingly serve as their touchstone. As Professor Kane observes, there exists widespread consensus among countries, for many assets, as to the identity of an asset's legal owner (*i.e.*, owner for tax purposes), and "[i]f one can design institutions and regimes that make good use of the natural points of intersection of the legal systems of various jurisdictions, then it would be foolhardy not to do so." [92]

Second, "the arm's length principle is [neither] the problem nor the solution to all the concerns expressed by countries in relation to cross-border taxation."[93] In many of

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[90] *See id.* ¶ 79.

[91] Asociacion Espanola de Asesores Fiscales, *supra* note 16, at 5. *Accord* International Tax Center Leiden, *supra* note 39, at 4 (warning that adoption of the functional approach could "open[] the door to enormous freedom for countries to object [to] one another's position as to what constitute[s] an 'important function,' what is the minimum number of own employees required, what is the level of competence and authority required and so forth").

[92] Kane, *supra* note 13, at 55-56. Kane emphasizes existing consensus regarding legal ownership in a defense of ALS against proponents of global formulary apportionment, which, he charges, "essentially *discards* the wide range of consensus over these many assets." *Id.* at 57. It does so by "converting legally distinct entities into a fictive unitary one." *Id.* Analogously, the Drafts' functional approach and disregard for legal ownership converts distinct transactions among MNE constituents into a single transaction for purposes of profit allocation.

[93] Baker & McKenzie Global Transfer Pricing Group and Global Tax Policy Initiative, *supra* note 49, at 4.

the headline-grabbing avoidance cases, manipulation of intangibles transfer pricing is merely one component of a multi-faceted tax minimization strategy, or it is simply not the problem. Apple, Inc.—the veritable poster-child of profits-shifting[94]—has accumulated a nearly-untaxed offshore cash pile of approximately $102 billion through arbitrage of countries' differing tax residency rules, treaty shopping, exploitation of U.S. entity classification rules, and leveraging exceptions to the U.S. controlled foreign corporations regime, all in addition to its reliance on a cost-sharing agreement.[95] Google, Inc. has avoided tax within Europe by maintaining its activities below the threshold that would trigger source-country taxation under treaty permanent establishment definitions.[96] Perhaps the BEPS Project's participants view changes to the global transfer pricing regime as comparatively low-hanging fruit, more politically palatable than elimination of domestic tax concessions and revision of other OECD standards that enable intangibles profits shifting. But revising the transfer pricing rules to force profit allocation in accordance with "people functions" may not solve, and may even exacerbate, the problem.[97]

Third, to the extent that abusive transfer pricing in the intangibles arena contributes to BEPS, tools to combat these abuses already exist. "[T]here is a more appropriate transfer pricing answer to situations in which the legal owner performs

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[94] *See Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.): Hearing Before the S. Permanent Subcomm. on Investigations*, ex. 1a, at 17, 113th Cong. (2013) (explaining that, of Apple's two foreign subsidiaries having no declared tax residency, at least one—Apple Operations International—had reported $30 billion of net income over the four-year period 2009-2012 but paid no corporate income tax anywhere during that time).

[95] *See Id.* at 5.

[96] *See, e.g.*, SELECT COMMITTEE OF PUBLIC ACCOUNTS, *supra* note 87.

[97] *See* Crowe Horwath, *supra* note 61, at 3 (citing "IP tax incentive mechanisms such as Patent/IP Box regimes . . . and/or specific anti-abuse measures . . . such as CFC regimes, deemed residence tests, blacklist rules requiring an active business test for deduction purposes, business purpose doctrine, etc." as "more efficient and better tailored to tackle abuses" and warning that absent progress on these other fronts, simply "attributing higher weight to functions . . . may even trigger the relocation of people functions in the low-tax jurisdictions where . . . assets are legally owned").

limited functions in respect of the creation of value in an intangible, which is the appropriate use of transfer pricing methods to value the services provided by other parties."[98] Most, if not all, OECD members' domestic laws define ownership of intangible property in the first instance—likely vesting the creator with initial ownership rights. If a transfer occurs, whether overtly pursuant to contract or in substance via registration of the intangible as owned by another group member, the creator's residence country should require arm's length consideration. To the extent that the transfer occurs pursuant to a cost-sharing agreement, governments and OECD have sanctioned and supervised these agreements[99] and should better police them for compliance with ALS. If entities within a legal owner's multinational group perform services or supply assets that enhance an intangible's value, tax authorities should characterize the transactions, identify comparables, and impose adjustments. Such adjustments may or may not consist of a share of the intangible-related return, depending on how comparable uncontrolled transactions are remunerated. This approach aligns with how companies behave at arm's length and with the domestic tax law norms discussed in Part IV of this Paper.

If OECD and its constituents now believe ALS theoretically unsound, they should revisit their commitment to it and present a normative argument for the new methodology. While ALS remains the lodestar of OECD transfer pricing, however, OECD should not adopt a different approach for intangibles that imposes non-arm's length results in controlled transactions and creates asymmetry with other tax law norms. OECD member governments may sense that they "gave away the store" in the

[98] Deloitte, LLP, *supra* note 32, at 17.
[99] *See* OECD, Guidelines, *supra* note 4, ¶¶8.8-8.25.

past through manipulable cost-sharing rules and/or lax enforcement, but adopting a new, inconsistent, and—according to OECD—unviable[100] transfer pricing approach for intangibles in an effort to claw back forgone revenue would constitute shortsighted and unprincipled policy-making.

[100] *See* OECD, Action Plan, *supra* note 21, at 14.