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The Allocation of Residual Profits Deriving from Intangibles in a Transfer Pricing Context

by

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HARN60 Master Thesis

Master's Program in European and International Tax Law

2016/2017

5th June 2017

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Acknowledgments

I experienced an exceptionally great year at Lund's University and for this I am very thankful. I especially want to thank Cécile Brokelind and Oskar Henkow for their support and encouragement throughout the entire year.

Further, I feel very lucky to have studied with the great bunch of people joining me in this program and owe special thanks to Bobby and Christos for being my partners in crime during the writing process of this thesis.

I will always look back at this time with a huge smile on my face and count myself very lucky to have had such a great experience in Sweden.

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Abstract

After giving an introduction to the basics of transfer pricing with a focus on intangibles, this paper aims to establish the nature of residual profits and what needs to be considered when such profits are generated. It will become clear that residual profits are an economic concept rather than an element of tax law which is why, first, a connecting link needs to be found between these two disciplines. Once it has been established whether or not residual profits form part of the notion of income as understood in tax law, the analysis will turn to the on-going dispute concerning the application of either the arm's length principle or formulary apportionment as best method with regards to the allocation of residual profits deriving from intangibles.

List of Abbreviations

Action Plan	Action Plan on Base Erosion and Profit Shifting
ALP	Arm's Length Principle
APM	Advertising, Promotion and Marketing
BEPS	Base Erosion and Profit Shifting
BEPS Project	OECD/G20 Base Erosion and Profit Shifting Project – Guidance on Transfer Pricing Aspects of Intangibles
CCCTB	Common Consolidated Corporate Tax Base
CUP	Comparable Uncontrolled Price Method
Discussion Draft	Public Discussion Draft BEPS Actions 8-10 Revised Guidance on Profit Splits
DTT	Double Tax Treaty
DEMPE Functions	Functions relating to the Development, Enhancement, Maintenance, Protection and Exploitation of Intangibles
EStG	Einkommensteuergesetz
FA	Formulary Apportionment
Final Report	Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports
G20	Group of 20
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
OECD MTC	Model Tax Convention on Income and Capital
PSM	Profit Split Method
R&D	Research and Development
TNMM	Transactional Net Margin Method
TP	Transfer Pricing

TPG

OECD Transfer Pricing Guidelines for Multinational
Enterprises and Tax Administrations

UN Manual

United Nations Practical Manual on Transfer Pricing
for Developing Countries

I. Introduction

1.1 Background – The Necessity for Transfer Pricing Rules

When entering into cross-border transactions, multinational enterprises (MNEs) can either choose to conduct business with third parties (independent enterprises) or their own group members (associated enterprises). While the prices set between companies that are in no way connected to each other usually are based on the rules of supply and demand, this is, however, not necessarily the case for companies belonging to the same group. Given the existing connections, be they legal or economic, associated enterprises may be tempted to price transactions in a manner unlike the one followed by independent companies, ultimately giving them advantages of one sort or another.¹

MNEs are in a position to set prices deviating from the ‘usual’ market price, simply because – within their group – they are not subject to market forces (*i.e.* supply and demand). As a result, an MNE can actively manipulate its tax base which has a direct effect on the corporate income tax it is required to pay in each of the countries it has positioned itself in.²

MNEs are, consequently, capable of shifting profits from one country to another, thereby creating scenarios in which they enjoy the most fiscal advantages possible. A multinational group, therefore, will find itself tempted to relocate profits away from high-tax jurisdictions to low-tax jurisdictions.³

As a reaction to the on-going profit shifting, the Organisation for Economic Co-operation and Development (OECD) concerned itself with the matter and came up with specific guidelines for States creating their domestic transfer pricing rules. These are the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TPG)⁴, which have been revised in course of the OECD/Group of 20 Base Erosion and Profit Shifting Project (BEPS Project), the most recent results of which (especially with regards to intangibles) were published in 2015 under the title “*Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*” (Final Report).⁵

The revision of the TPG through the BEPS Project was necessary in order to protect the States’ tax revenue and to prevent tax-motivated profit shifting.⁶ Several States, consequently, started to implement provisions that could prevent the MNEs’ practice to

¹ J. Monsenego, *Introduction to Transfer Pricing* (The Netherlands: Kluwer Law International BV, 2015), p. 3.

² *Ibid.*, p. 4.

³ T. Zinn/N. Riedel/C. Spengel, “*The Increasing Importance of Transfer Pricing Regulations: A Worldwide Overview*” (2014), vol. 42, issue 6 & 7, *Intertax*, p. 352.

⁴ OECD (2010), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing, (OECD TPG).

⁵ OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 9, 10; available at: <http://dx.doi.org/10.1787/9789264241244-en>; (Final Report).

⁶ T. Zinn/N. Riedel/C. Spengel (n. 3), p. 352.

tamper with transfer prices. In most of the cases, intra-group transactions are since tested against the arm's length principle (ALP), according to which the *modus operandi* of the tested transaction has to lead to an outcome similar to what would be the case between independent companies interacting in comparable circumstances.⁷

Base erosion and profit shifting (BEPS) as such emerged with the steadily increasing globalisation. The opening of international markets led to more frequent trade and direct foreign investment activities and MNEs started playing a bigger role in the economy. As a logical consequence, cross-border intra-group trade increased, subjecting MNEs to several (tax) jurisdictions around the world. It is needless to say that tax planners jumped at the opportunity to exploit the effects different tax rules have on each other, resulting in less than single taxation, double non-taxation or allowing for other forms of base erosion and profit shifting.

Tax authorities saw themselves, as a consequence, confronted with situations in which the gaps – created through the application of different national tax regimes or through double tax treaties (DTTs) – caused income deriving from cross-border transactions to be taxed at too low a rate, or even not being taxed at all.⁸

The BEPS Project, further, in its Final Report concerned itself specifically with transfer pricing issues, in particular with problems relating to intangibles, cost contribution arrangements, profit splits as well as risk and capital.

The guidance given in the Final Report ultimately aims at ensuring that value creation and transfer pricing arrangements are in line with each other. In other words, the rules laid down in the Final Report should guarantee that operational profits deriving from certain economic activities be allocated to where they arose in the first place.⁹

In summary, transfer pricing rules have become necessary because the opening of international markets for multinational enterprises has led to situations in which they were able to shift their profits from high-tax jurisdictions to low-tax jurisdictions, thereby achieving the best possible tax treatment for themselves.

As is often the case, however, where a winner is found, a loser cannot be far. The tax planning activities of MNEs came to the detriment of those States from which profits were shifted away, causing a loss in their tax revenue. Not wanting to remain in a losing position, they fought back by implementing transfer pricing rules, which, especially through application of the arm's length principle, are meant to ensure the correct pricing of transactions amongst associated enterprises. Where a transaction within a group would not have been concluded under (nearly) the same circumstances between independent companies, the tax authorities would now have the power to adjust the profits made between associated enterprises.¹⁰

⁷ T. Zinn/N. Riedel/C. Spengel (n. 3), p. 352.

⁸ OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, p. 7-10; available at <http://dx.doi.org/10.1787/9789264202719-en>; (Action Plan).

⁹ C. Panayi, "International Tax Law Following the OECD/G20 Base Erosion and Profit Shifting Project" (2016), *Bulletin for International Taxation*, p. 630, 641, 642.

¹⁰ Art 9, OECD (2015), *Model Tax Convention on Income and on Capital 2014 (Full Version)*, OECD Publishing; available at: <http://dx.doi.org/10.1787/9789264239081-en>; (OECD MTC).

In course of the BEPS Project the Final Report was published which revised the existing transfer pricing guidelines, especially with regards to intangibles. Its aim is to bring outcomes of transfer pricing arrangements in line with value creation and, thereby, to ultimately ensure that tax bases are not eroded.¹¹

As will become evident throughout this paper, intangibles, especially the allocation of residual profits deriving therefrom, put the TP rules as applied at the moment at a test that has led to considerable discussions.

1.2 Purpose

The purpose of this paper is to point out and analyse the problems that occur when it comes to the allocation of residual profits deriving from intangibles.

As a starting point to this analysis the paper will try to draw a connection between residual profits as an economic concept and tax law in order to justify the taxation of such profits in the first place. The origin of the link to these two disciplines will be examined in the light of the notion of income as an element of tax law.

Once this connection has been drawn, the paper will establish whether or not the allocation of residual profits is in line with transfer pricing standards, especially the ALP.

The issue that arises in the context of intangibles and their ability to generate residual profits is the question of allocating such profits amongst the contributing affiliated entities. The TPG suggest that in cases where no comparables can be found (which is often the case with intangibles) a profit split method should apply.¹²

The proposal to apply a PSM, however, has led to great discussion with regards to the ALP which constitutes a core element of transfer pricing. In course of this analysis the paper will, therefore, also refer to formulary apportionment as an alternative method and discuss which, if any, of the presented methods is the most appropriate for the allocation of residual profits.

1.3 Methods and Materials

The question of how to allocate residual profits deriving from intangibles is discussed in a legal-dogmatic manner. This method takes an internal perspective by referring to the positive law as it stands. The purpose of this kind of research is to identify ways to improve the coherence and ensure the consistency of the legal system.¹³

This paper is based on Art 9 of the OECD MTC in combination with several works published by the OECD in the course of the OECD/G20 BEPS Project. Although of non-binding character, these sources represent the framework and basis for national transfer pricing legislation, which is why this analysis refers back to them in order to take a general, rather

¹¹ Final Report (n. 5), p. 13.

¹² Ibid., p. 60 at 2.4.

¹³ S. Douma, *Legal Research in International and EU Tax Law* (Kluwer 2014), p. 17, 18.

than a country-specific, approach to the issue at hand. It is, moreover, argued that the Guidelines, which constitute soft law, are “*arguably more important than any “hard law” on transfer pricing*”.¹⁴

The analysis is backed up by academic literature, while reference is also made to the debates that the allocation of residual profits has triggered.

The research made to this paper ends with fifth of June 2017.

1.4 Delimitation

As mentioned above, the analysis of the question at hand is based on the OECD TPG and takes an international approach in search for an answer on how to allocate residual profits deriving from intangibles. It is, therefore, to a large extent, outside the scope of this paper to refer to any particular national transfer pricing legislation.

Since the United Nations Practical Manual on Transfer Pricing for Developing Countries¹⁵ (UN Manual) faces the same, or at least similar issues regarding the ALP, it does not need to be explicitly mentioned. It will suffice to say that the UN Manual also allows for the application of the profit split method or a formulaic approach, thereby stretching the ALP.¹⁶ In that regard, it is sufficient to use the OECD TPG by way of example.

This paper also does not refer to any EU-case law due to the lack thereof on specifically the allocation of residual profits and the application of the residual profit split method. The author is aware of the existence of U.S.-cases regarding these issues, but, is of the opinion that, for the purpose of this paper, the presented case based on OECD material will be sufficient to point out the difficulties arising with regards to residual profits.

Since this paper is, furthermore, part of a law programme, accounting and economic questions will, where necessary, only be considered on a very basic level, although transfer pricing in general, and the residual profits in particular, are certainly closely connected to these subjects.

1.5 Outline

This paper is divided into two major parts. Part I is especially intended to guide readers with no or little experience in transfer pricing through its basics and will therefore be presented in a rather descriptive manner. It will, further, touch upon the special features of intangibles in a transfer pricing context.

¹⁴ J. Li, “Soft Law, Hard Realities and Pragmatic Suggestions: Critiquing the OECD Transfer Pricing Guidelines” in W. Schön/K. Konrad, “Fundamentals of International Transfer Pricing in Law and Economics (Springer 2011), p. 79.

¹⁵ UN, Department of Economic & Social Affairs (2013), *United Nations Practical Manual on Transfer Pricing for Developing Countries*.

¹⁶ M. Koomen, “*Transfer Pricing in a BEPS Era: Rethinking the Arm’s Length Principle – Part I*” (2015), *International Transfer Pricing Journal*, p. 144.

Part II will then dive into the depths of profit allocation and will take a more critical approach to the topic, pointing out the problems and disputes that have arisen with regards to residual profits.

As a starting point, the arm's length principle will be explained, focusing on the functional and comparability analysis (Chapter 2). Following, the different transfer pricing methods will be touched upon (Chapter 3). A separate chapter will be devoted to intangibles and the specifics relating to them in a transfer pricing context (Chapter 4). Chapter 5 will consist of an example pointing out the problems of profit allocation, and thereby preparing the reader for the discussion at the core of this paper. Chapter 6, as the final chapter of part I, will focus on the profit split method.

The core analysis of this paper will begin with a problem-orientated discussion of residual profits (Chapter 7) and the arm's length principle (Chapter 8) as well as the profit split method (Chapter 9). Chapter 10 will present formulary apportionment as an alternative for profit allocation and Chapter 11 will consist of a comparison between the arm's length principle and the method of formulary apportionment with the goal to establish which of the two is to be preferred.

Finally, a conclusion of the foregoing analysis will be drawn.

PART I

II. The Arm's Length Principle

2.1 General Remarks

The fact that controlled transactions between members of an MNE can be made subject to atypical conditions and therefore do not necessarily follow market forces gives rise to the application of the arm's length test. Should this test, after examining the controlled transaction, come to the conclusion that independent companies would not have entered into relations under the given intra-group conditions, tax administrations might be authorized to impose taxes not only on the profits actually generated, but also include those profits which the entity would have made if it had not been for any special conditions. The ALP, for that reason, examines first and foremost the prices set by associated enterprises, because mispricing is considered the most obvious means for companies to shift profits from one jurisdiction to another.¹⁷

Other than preventing tax base erosion, the ALP also sets a barrier to the distortion of competition since it ensures, to a broad extent, equal tax treatment of associated and independent enterprises, making it more difficult for the former to create tax advantages for themselves.¹⁸

This principle, however, is not without its shortcomings. It can be argued that MNEs and independent companies are not comparable, because while associated enterprises are in a position to pursue a common goal, not all of the transactions need necessarily benefit every single member of the group. Independent entities, on the other hand, are most likely to enter into transactions only if they are advantageous to them. As 'single players' they do not (have to) take into account anyone's interests but their own.¹⁹ Additionally, synergy effects are not considered in the arm's length test although they have an influence on a company's income and, together with the lack of eligible comparables, the ALP cannot always provide for a level playing field between associated and independent companies.²⁰ Some of these issues will be dealt with in more detail further along in this paper.

Before a comparison of the controlled transaction with an independent transaction can be made, the scope of what is being compared needs to be established. This is done in two steps, beginning with a functional analysis followed by a comparability analysis.

¹⁷ A. Bullen, *Arm's Length Transaction Structures – Recognizing and restructuring controlled transactions in transfer pricing*, (The Netherlands, Volume 20, Doctoral Series IBFD – Academic Council, 2011), p. 3, 4.

¹⁸ OECD TPG (n. 4), p. 34 at 1.8.

¹⁹ J. Monsenego (n. 1), p. 19.

²⁰ B. Stieber/R. Macho, „*Verrechnungspreise und Fremdvergleich – Wie flexibel ist der lange Arm?*“ (2012), Heft 9, taxlex, Manz, p. 370.

2.2 The Functional Analysis

The functional analysis examines which role each of the involved associated enterprises plays in a given transaction. As a rule, the more important of a position a company obtains, the more it should be exposed to the benefits or negative effects of the transaction, *i.e.* the group member will enjoy (a greater part of) the profits made, or will have to carry the burden of occurring losses.²¹

Under the ALP, the (proportional) allocation of profits is based on an analysis of the functions a group member performs, which risks it assumes and which assets it uses. A starting point to determining a group company's involvement in a transaction is to check existing contractual agreements. Should it emerge, however, that the actual conduct of the parties is contrary to the content of the contract, when assessing the roles of each company, the Final Report prioritises real-life occurrence. In terms of actual conduct, control over and the ability to financially bear a risk are the decisive factors for determining the risk-bearing party and, ultimately, the entitlement to arm's length compensation ("substance over form").²²

The result of the functional analysis will show how much each involved company adds to the value of the transaction in relation to what other group members have contributed and should finally lead to a clear portrayal of the transaction under examination. Further, it will establish how much each party has contributed to, and is involved in, the economic outcome of the intercompany transaction.²³

This analysis is only the first step towards finding an appropriate transfer price or correctly allocating profits or losses. The next step to figure these points out consists of a comparability analysis.

2.3 The Comparability Analysis

In order to determine whether the price set between associated enterprises reflects what would have been agreed upon between independent companies, a comparison between the controlled transaction and an uncontrolled transaction has to be made. Apart from the functional analysis, there are four additional factors which help to establish comparability.

A price, accordingly, complies with the ALP if the characteristics of property or services, the contractual terms, economic circumstances and business strategies are comparable. The key, consequently, to finding a suitable comparable (*i.e.* a comparable transaction/company) is to make sure that similar circumstances between the controlled and uncontrolled business-deal can be found. In any case, no such comparable can be used that is found within the group. In other words, the comparable has to be independent from the tested party.²⁴

²¹ OECD TPG (n. 4), p. 45 at 1.42, 1.45.

²² J. Wittendorff, "At Arm's Length – BEPS Actions 8-10: Birth of a New Arm's-Length Principle" (2016), Tax Notes International, p. 332.

²³ J. Monsenego (n. 1), p. 22, 23.

²⁴ P. Fris/S. Gonnet, "The State of Art in Comparability for Transfer Pricing" (2010), International Transfer Pricing Journal, p. 99-102.

The comparability test can be conducted in two different ways. One is to examine “internal comparables”, in which case a transaction taking place between an associated and an independent company is compared to the purely internal business deal. The other way is to take a look at “external comparables”, where transactions between only unrelated entities are examined so as to test the prices set within a group against the ALP.²⁵

Comparability is given as long as any differences between the compared facts cannot materially affect the price or margin under examination or, if differences are given, as long as adjustments can be made in an accurate manner to eradicate the differences.²⁶

Should the result of the test show that the “MNE price” is not at arm’s length, national laws will often allow the tax authorities to adjust a mispriced transaction, thereby rectifying the faulty income allocation. This, however, might lead to a risk of double taxation of MNEs, since each State has different rules concerning income allocation.²⁷

To prevent double taxation, therefore, an adjustment made in one State should be equalized by a corresponding adjustment in the other involved State.²⁸

Without wanting to give too much away, the author cannot stress enough that a successful comparability analysis, or comparability for that matter, depends on the existence of a suitable comparable.

To put the functioning of the ALP very bluntly, if there is nothing to compare, no price can be tested against it.

Or can it?

For now, this question can remain floating in the reader’s head.

Instead, the paper will continue with some basics on transfer pricing methods and the treatment of intangibles in a transfer pricing context.

III. Transfer Pricing Methods

The purpose of transfer pricing methods is to establish a price that passes the arm’s length test. Their application intends to either determine the correct price beforehand or to test already set prices of intercompany transactions.²⁹

The five methods mentioned in the OECD TPG are the comparable uncontrolled price method (CUP), the resale price method, the cost plus method, the transactional net margin method (TNMM) and the transactional profit split method (PSM).

²⁵ J. Monsenego (n. 1), p. 24.

²⁶ OECD TPG (n. 4), p. 42 at 1.33.

²⁷ A. Pichhadze, “*The Arm’s Length Comparable in Transfer Pricing: A Search for an “Actual” or “Hypothetical” Transaction?*” (2015), World Tax Journal, vol. 7, no. 3, p. 2, 3.

²⁸ OECD TPG (n. 4), p. 140 at 4.32.

²⁹ J. Monsenego (n. 1), p. 37.

They can be divided into “traditional transaction methods” (CUP, resale price and cost plus) and “transactional profit methods” (TNMM and PSM). The OECD Guidelines, further, distinguish between two groups of transfer pricing methods.³⁰ One group consists of the price-based methods which turn to market data, margins or indicators deriving from profit levels (*i.e.* CUP, resale price, cost plus and TNMM). The other group consists of the profit-based method which is relied upon when the market does not provide for a direct comparable (PSM). The methods can be, further, split into one-sided methods (resale price, cost plus and TNMM) and two-sided methods (CUP and PSM). While the one-sided methods focus only on one of the parties to the intra-group transaction, the two-sided methods consider both parties.³¹

For the purpose of this paper and at this stage of the analysis it will suffice to mention that, with regards to choosing the “right” method, the OECD TPG suggest using the most appropriate one for the case at hand. Appropriateness is determined by reference to the concrete characteristics of the controlled transaction (functional analysis). Further factors influencing the choice of method will be the availability of sufficient information, or the question of whether there are sufficiently comparable transactions at all.³²

The transactional profit split method will, however, be subject to greater discussion further along.

In the meantime, the treatment of intangibles for TP purposes shall be discussed in order to complete the picture one should have before the allocation of residual profits deriving from intangibles can be discussed.

IV. Intangibles

4.1 General Remarks

Globalization, together with deregulations in various sectors, digitalization and the growing importance of the service sector have transformed economies, from primarily production-based to being strongly knowledge-based. As a consequence, the use of intangibles has become of great importance for businesses around the world.³³

On the one hand, with the growing importance of intangibles for MNEs in mind, the question of ownership and income allocation became more significant, resulting in MNEs shifting profits in ways that have reduced their tax base in high-tax jurisdictions.³⁴ On the other hand,

³⁰ OECD TPG (n. 4), p. 59 at 2.1.

³¹ C. Peng, “*The Application of the Arm’s Length Principle to the Allocation of Joint Efficiencies within MNEs*” (2016), *International Transfer Pricing Journal*, p. 383.

³² OECD TPG (n. 4), p. 59 at 2.2.

³³ M. Lagarden, “*Intangibles in a Transfer Pricing Context: Where does the Road Lead?*” (2014), *International Transfer Pricing Journal*, p. 331.

³⁴ J. Wittendorff, “*Valuation of Intangibles under Income-Based Methods – Part I*” (2010), *International Transfer Pricing Journal*, p. 323.

tax administrations had to watch how these companies created base erosion scenarios by “abusing” contracts, in so far as they allocated the legal ownership to a member of the group which did not in fact perform any functions relating to the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangibles.³⁵ The OECD’s reaction to this issue was to align transfer pricing outcomes with value creation rather than allowing for a separation of these two elements.³⁶

Before pointing out the mechanisms through which this is achieved when dealing with intangibles in a transfer pricing context, a definition of intangibles will be given.

4.2 The Definition of Intangibles

For transfer pricing purposes intangibles are defined as

*“something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.”*³⁷

In order to decipher this cryptic definition and paint a more vivid image of what constitutes an intangible, one might think, for example, of trademarks.

The purpose of a trademark is to make an owner’s product distinguishable from others by giving it an exclusive name or by adding a unique logo, symbol or picture to it. The right to ownership of a trademark is often confirmed through registration, and enables the owner to keep competitors from using the trademark in a way that could cause mix-ups on the market. Unlike patents, trademark protection is not limited to a certain amount of time, as long as its registration is regularly renewed and it is used on a continuing basis. Goods or services may equally be registered under a trademark.³⁸

This is only one of the many items that is considered an intangible in transfer pricing. Others can be patents, know-how, brands etc.³⁹

4.3 The Transfer Pricing Process of Intangibles

Just like any intra-company transaction, a transfer price for intangibles needs to be determined according to the ALP.

In this regard, the Final Report states that, after delineating a transaction, it might be the case that legal ownership alone does not entitle a group member to returns achieved through the

³⁵ A. Hickman/M. Brown/M. Lucas, “Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation” (2016), International Tax Review, p. 16.

³⁶ Final Report (n. 5), p. 11.

³⁷ Ibid., p. 67 at 6.6.

³⁸ Ibid., p. 71 at 6.21.

³⁹ Ibid., p. 70, 71.

exploitation of intangible assets. Any associated company that performs functions of significant weight or assumes a high degree of economic risks while contributing its own assets can expect to receive an appropriate return relative to the value it adds to an intangible through its contributions.⁴⁰

The remuneration of the involved parties is determined by taking the following steps.

4.3.1 Analysing Transactions Involving Intangibles

“The framework for analysing transactions involving intangibles between associated enterprises requires taking the following steps [...]:”⁴¹

As a first step, it is necessary to identify with specificity which intangibles are used or transferred. Further, an identification of certain risks of economic significance connected to the DEMPE functions is recommended.

The next step requires an analysis of contractual arrangements, whereby emphasis should be put on determining the legal owner of the intangibles in question, and which of the associated enterprises assumes risks.

A functional analysis will, additionally, identify the parties involved in the development, enhancement, maintenance, protection and exploitation of intangibles in terms of performing functions, using assets and assuming risks.

Once the contractual arrangements have been identified it needs to be established whether they are in line with the actual conduct of the parties and especially, whether the party, which contractually was assigned the assumption of risks, actually controls them and has the financial means to assume those risks. This should ultimately lead to a fixed price for each of the intra-group transactions at arm’s length.⁴²

The purpose of this framework is to ensure that all group members of an MNE that perform functions, contribute assets and assume risks are appropriately compensated.⁴³ In other words, legal ownership does not automatically mean entitlement to profits as will be seen in the following.

4.3.2 Ownership of Intangibles

“Although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the legal owner’s MNE group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible.”⁴⁴

⁴⁰ Final Report (n. 5), p. 10.

⁴¹ Ibid., p. 74 at 6.34.

⁴² Ibid., p. 74, 75 at 6.34.

⁴³ M. Pankiv, “Post-BEPS Application of the Arm’s Length Principle to Intangible Structures” (2016), International Transfer Pricing Journal, p. 465.

⁴⁴ Final Report (n. 5), p. 74 at 6.32.

The revision of Chapter VI of the BEPS Project resulted in a new approach regarding ownership of intangibles. Legal Ownership is no longer the decisive, but rather the starting point for the allocation of profits. In cases in which contracts, or the applicable law, do not define a legal owner, the entity which controls decisions in connection to the exploitation of intangible goods, and has the power to restrict other entities from using them, will be regarded as the legal owner.⁴⁵

As long as the owner performs several DEMPE functions and controls them, while providing several assets needed (including funding), and bearing all risk associated with the development, enhancement, maintenance, protection and exploitation of intangibles at the same time, is the owner entitled to keep all the anticipated returns stemming from the exploitation of the intangible.⁴⁶

This does not mean, however, that the entity in question has to perform all these functions “personally”. The legal owner can outsource some of the DEMPE functions and still be entitled to receiving (all) the returns, if control over the risks and the financial capacity to bear them remain with the legal owner.

Under the newly introduced ‘DEMPE standard’, however, an associated company that creates value in the supply chain with regards to the development, enhancement, maintenance, protection and exploitation of an intangible, should be compensated for the valuable contributions it makes.⁴⁷

Once the question of legal and economic ownership has been answered, the returns deriving from the exploitation of an intangible have to be divided between the contributing entities. This can, as a matter of fact, turn out to be problematic as will be discussed in the following.

4.3.3 Allocation of Returns

“Applying the provisions of Chapters I-III to address these questions can be highly challenging for a number of reasons. Depending on the facts of any given case involving intangibles the following factors, among others, can create challenges.”⁴⁸

The Final Report states that returns resulting from the exploitation of an intangible, as well as the costs relating to intangibles are allocated based on the value-enhancing contributions each group member has made. The contributions are identified by analysing the functions a group member performed, the assets it used and the risks it assumed during the development, enhancement, maintenance, protection and exploitation of the intangibles.⁴⁹

Difficulties of allocation according to the ALP, the TP methods and the comparability of transactions (Chapters I-III TPG) can arise, however, if the controlled transaction involving

⁴⁵ M. Pankiv, (n. 43), p. 465.

⁴⁶ Final Report (n. 5), p. 84 at 6.71.

⁴⁷ A. Storck/R. Petrucci/M. Pankiv/R.J.S Tavares, “Global Transfer Pricing Conference “Transfer Pricing in a Post-BEPS World” (2016), International Transfer Pricing Journal, p. 218.

⁴⁸ Final Report (n. 5), p. 74 at 6.33.

⁴⁹ Ibid., p. 73, 74 at 6.32.

the intangibles were not to occur in a comparable way between independent entities or if the intangibles are not comparable at all.

Problems may appear, additionally, because different group members of the MNE own and/or use different intangible assets.

It is, further, difficult to assess which impact an intangible has on the overall income of the MNE. The fact that more than one of the associated entities might perform DEMPE functions can lead to complications, because these functions are performed with a high level of integration that cannot be found between entities which do not stand in any relation to each other.⁵⁰

In all these cases it is not easy to accurately delineate the contributions each of the group members made to the transaction.

Keeping these difficulties in mind, the allocation of profits will now be presented.

V. The Process of Profit Allocation

5.1 General Remarks

This chapter will explain the process of profit allocation amongst affiliated companies by means of an example involving marketing intangibles. According to the Final Report a marketing intangible is

“An intangible [...] that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned.”⁵¹

Given the specificities of each case, marketing intangibles could consist of trademarks, customer lists, specific data, etc.⁵² Their typical feature is, in any case, to further marketing and to increase sales of goods or services, thereby adding to the value of, for example, a brand.⁵³

The starting point to the presented example is the fact that through its marketing activities, a local distributor contributes to the value of intangibles it does not own and needs to be compensated for its activities in one way or another.

In general, and to recall what has partly already been touched upon, the extent to which an associated enterprise should be reimbursed for its contributions is assessed by an analysis of

⁵⁰ Final Report (n. 5), p. 74 at 6.33.

⁵¹ Ibid., p. 69.

⁵² Ibid., p. 69.

⁵³ S. Wagh, “Transfer Pricing Aspects of Marketing Intangibles: An Indian Perspective”(2015), Bulletin for International Taxation, p. 520.

- The rights and obligations deriving from legal registrations and what has been agreed upon between the parties;
- The functions performed, assets used and risks assumed by each of the parties;
- The expected value contributed by the marketer through its activities and
- The compensation the marketer is given for his activities.⁵⁴

With the following case of the fully-fledged distributor, the issues presented in theory above will hopefully become more evident. The example will show that theory and practice do not harmonize as easily as one would have expected.

5.2 The Case of the Fully-Fledged Distributor

Assume that company A, resident in State X is the registered owner of a certain trademark and trade name, connected to special tables it manufactures (“T”). Due to A’s own marketing activities, T is known in several States and has developed great economic value in the respective markets.⁵⁵

Yet, T is not known and has never been introduced to the market in State Y before A decided to create a wholly owned subsidiary (S) in Y with the intention to establish T there.

S is meant to act as distributor for A under a royalty-free marketing and distribution contract according to which S has the exclusive right to advertise and sell tables, both placing the trademark T on them, and using the trade name in State Y.

The marketing and distribution agreement is long-term, giving these exclusive rights to S for a time period of five years with the option to prolong said agreement for another five years.

According to the contract, development and execution are assigned to S. As a matter of fact, S even performs extensive marketing functions and bears marketing expenses which by far exceed what comparable independent companies would take upon themselves. The high level of these expenses can be traced back to extraordinary or more intensive functions that S performs in comparison to entities in comparable situations.

S and A expect to achieve higher profit margins and higher sales through the increased performance by S. This also means that S contributes more extensively to the development of T and its establishment on the market, and, consequently, incurs greater costs and assumes more risks than an independent company normally would. S will, as a consequence, make significantly lower profit margins than enterprises that do not perform additional or more extensive functions.⁵⁶

Compared to independent companies, and due to the excess functions and expenses S sees itself confronted with, it can be concluded that S will, in the end, not receive appropriate compensation through the margins it earned by selling the “T-tables”.⁵⁷

⁵⁴ Final Report (n. 5), p. 86 at 6.77.

⁵⁵ Ibid., Example 8, p. 121, para. 20.

⁵⁶ Ibid., Example 10, p. 123, para. 31.

⁵⁷ Ibid., Example 10, p. 123, para. 33.

The Final Report suggests three different options⁵⁸ for a transfer pricing adjustment in such cases.

For the purpose of this paper, however, only the adjustment based on a residual profit split method will be examined.

VI. The Profit Split Method

6.1 General Remarks

Following up to the example of the fully-fledged distributor (see above, 5.2), the facts of the case make it nearly impossible to find a comparable independent entity because the associated subsidiary performs functions and incurs costs that greatly exceed what an independent company would take upon itself in a comparable situation. The subsidiary is, consequently, not appropriately compensated given the margins earned by selling the trademarked tables do not cover the expenses it incurred.

According to the OECD TPG, in situations where highly integrated activities take place, or more than one party makes unique and valuable contributions to the controlled transaction, it will be difficult to find an appropriate intangible. In such cases, the application of PSM might appear to be more appropriate.⁵⁹

Before this paper concerns itself with the attribution of profits in “incomparable” transactions, the notion of “residual profits” shall be explained.

It should further be noted that, although the following analysis only mentions “profits”, losses are equally allocated under a PSM.⁶⁰

6.2 The Coming into Existence of Residual Profits

It is not unheard for MNEs, or any companies for that matter, to seek to maximize their profits while also keeping their costs low. MNEs can reach this objective through cross-border activity or through strategic organisation of their value chains leading to cost-savings.

A further objective of MNEs is to set themselves apart from their competitors, which they achieve through research and development (R&D) and marketing activities aiming to develop and establish their brand, while optimizing their production process also adds to the overall success of the product. Following an individual strategy, therefore, will create a recognition value of the MNE which allows it to differentiate itself from its competitors in the market. Its activities will lead to the existence of non-routine assets, whose effect is to enable an MNE to create value that exceeds original investments.⁶¹

⁵⁸ Final Report (n. 5), Example 10, p. 123, para. 33.

⁵⁹ OECD TPG (n. 4), p. 60 at 2.4.

⁶⁰ Ibid., p. 93 at 2.108.

⁶¹ N. Lostumbo/R. Decker/A. Dust/R. Dadzie, “*Profit Splits Post-BEPS: Quantifying an MNE’s Intangibles*” (2015), Tax Notes International, vol. 80, no. 8, p. 709-710.

To exemplify the above, assume that an MNE plans to introduce a new trademark in State A and wants to ensure that the trademark already established in State B remains in a leading market position. In either case, the entity (which is not the entity legally owning the trademark) located in the respective States is confronted with expenses relating to advertising, promotion and marketing (APM) of the product. Depending on the success of the APM performance, the trademark might lead to an increased value of the product.

The “bonus” the trademark adds to the product is the result of the difference between the profits made through the exploitation of comparable “no-name” products to profits deriving from the “branded” product. In other words, the successfully promoted trademark will allow the MNE to generate additional proceeds. As a consequence, not only can all the contributing group members of the MNE be compensated for their routine contributions, but also will profits remain. These profits are the so-called residual profits.⁶²

With this example in mind, the idea behind the PSM will be presented.

6.3 The Profit Split Method in Theory

The PSM has the ability to consider the specificities and unique characteristics of “incomparable” transactions and is therefore more flexible in comparison to other TP methods. A profit split analysis is capable of determining arm’s length prices in circumstances where a division of the performance of routine and non-routine activities within an MNE is not clear-cut. This would, for example, be the case where unique and valuable intangibles are developed.⁶³

The transactional profit split method focuses its analysis on the profits resulting from an intra-group transaction (as opposed to prices which is the focus of the other TP methods). Profits can be seen as significant indicators of the conditions under which a transaction took place. To put it differently, the profits derived from a specific internal transaction might turn out to be higher or lower if independent companies had been involved, due to the external transaction not being subject to special intra-group conditions.⁶⁴

6.3.1 The *Modus Operandi* of the PSM

The PSM is performed in two-steps. First, the profits that should be divided amongst the contributing parties need to be identified. These profits are referred to as “combined profits” and derive from the controlled transaction the group members entered into. Once the profits have been evaluated, they are split based on economic considerations and allocated to the associated parties. Those economic considerations are built similarly to how independent companies would have divided the anticipated profits amongst each other under comparable circumstances.⁶⁵

⁶² D. Hack, „*Marketing intangibles im internationalen Konzern – wer erhält daraus den Gewinn?*“ (2008), taxlex, p. 179.

⁶³ M. Milewska/M. Hurtado de Mendoza “*The Increasing Importance of Intangible Assets and the Rise of Profit Split Methods*” (2010), International Transfer Pricing Journal, p. 162.

⁶⁴ OECD TPG (n. 4), p. 77 at 2.57.

⁶⁵ Ibid., p. 93 at 2.108.

6.3.1.1 Step One: Identifying the Combined Profits

First and foremost, the relevant transactions that should be subject to a profit split need to be identified, and it needs to be established whether a number of transactions, which all stem from different contracts, can only be evaluated together because they are so closely connected to each other.⁶⁶

Different accounting standards and currencies should also be considered and adjusted for, if they were not put on a common basis beforehand.⁶⁷

6.3.1.2 Step Two: Splitting the Combined Profits

The underlying principle to splitting the profits is to estimate as accurately as possible how profits would have been split if independent companies had realised them.⁶⁸

Any allocation keys that are used when splitting profits should be detached from any TP policies and rely on objective data, meaning data received from independent transactions. Such information can be obtained, for example, by analysing joint-venture agreements, collaborations, co-marketing agreements etc. concluded by independent entities.⁶⁹

6.3.2 Approaches for Splitting the Profits

6.3.2.1 The Contribution Analysis

This approach to splitting profits seeks to determine the relative value of a related entity's contributions to the transaction. On the basis of this approach lies the correlation between capital that is being invested and resulting operating profits.

A contribution analysis is especially suitable where the expenditures relating to the development of an intangible are constant, and are expected to be incurred throughout the useful life of the intangible at the same time.

Alternatively, the contribution analysis can also be based on labour costs. Relying on labour costs is practical if a specific individual creates the economic value of the intangible.⁷⁰

A contribution analysis ultimately aims to quantitatively assess which group member made which contributions to the transaction, resulting in an allocation of the profits according to the arm's length principle. As a result, and after applying the TP method most appropriate to the case at hand, a suitable transfer price is determined.⁷¹

⁶⁶ OECD TPG (n. 4), p. 98 at 2.124 and p. 111 at 3.11.

⁶⁷ Ibid., p. 98 at 2.125.

⁶⁸ Ibid., p. 95 at 2.115.

⁶⁹ Ibid., p. 101 at 2.132 and 2.133.

⁷⁰ M. Milewska/M. Hurtado de Mendoza (n. 63), p. 163.

⁷¹ S. Gonnet/P. Fris, "Contribution analyses under the profit split method" (2007), International Tax Review, p. 8.

6.3.2.2 The Residual Profit Split Analysis

The residual profit split analysis consists of two stages. In the first stage, the functions, assets and risks attributable to each of the related participants are categorized as routine or non-routine functions. The second stage first assigns an arm's length return to the group members for the routine functions they performed. Based on an appropriate location key, residual profits are, subsequently, split between the contributing entities.⁷²

The TPG emphasise that the remuneration for the identified routine functions results from the application of either traditional transaction methods or the TNMM since it is likely that comparables can be found for such activities.⁷³

Coming back to the brainteaser regarding the question of whether an arm's length test can be made in the absence of comparables, the PSM indicates that it is, indeed, possible. The application of the PSM has, exactly for this reason, caused havoc in the transfer pricing world, which is why Part II of this paper will now examine what the fuss is all about.

⁷² S. Gonet/P. Fris (n. 71), p. 163.

⁷³ OECD TPG (n. 4), p. 97 at 2.121.

PART II

VII. Residual Profits Revisited

7.1 General Remarks

At this point it will be necessary to establish what residual profits really are. In this regard, their origin and status in tax law need to be determined. Following this analysis, their effect on transfer pricing and tax law as a whole will be analysed.

As stated before (see 6.2, above), residual profits are some kind of “bonus” an MNE achieves through its intangibles as compared to a product whose value has not been enhanced through “special features”. This “bonus”, however, can be put in different contexts. Residual profits can, for that matter, be considered an economic concept but the question is, whether they also have a place in tax law. This will be subject of the following study.

7.2 Residual Profits as an Economic Concept

On an economic level, residual income is used when evaluating the economic value of a business. An entity’s value is composed of its value as represented in its books including the prevailing value of the entirety of future residual income.

Residual income, further, is used as a means to measure the performance of an entity. Residual income is, accordingly, that part of the overall income that exceeds the normal (expected) return when capital is invested.⁷⁴

This definition reflects the bonus as described in section 6.2, by means of which economic and accounting standards have found their way into transfer pricing. The question that remains, however, is if residual profits form part of income, in the sense that the economical notion of residual profits can be subsumed under tax law and its notion of taxable income.

7.3 Do Residual Profits Exist as a Concept in Tax Law?

To answer this question, income as such needs to be defined. This task, however, proves to be more difficult than expected as there is no single definition of income.

Taking a look into the Cambridge English Dictionary, an entity’s income is defined as the profit it generates within a certain time-period.⁷⁵

Corporate income tax according to the OECD constitutes of the net profits of a company. These are, in turn, defined as the difference between the gross income and permitted deductions.⁷⁶

⁷⁴ J. O’Hanlon/K. Peansell, “*Residual Income and Value-Creation: The Missing Link*” (2002), Review of Accounting Studies, vol. 7, p. 229.

⁷⁵ Cambridge Advanced Learner’s Dictionary & Thesaurus, Cambridge University Press, 2017; available at: <http://www.dictionary.cambridge.org/dictionary/english/income>.

Yet another definition can be found, for example, in the Austrian *Einkommensteuergesetz* (EStG; Income Tax Law) where income is considered to be the total sum of revenues made less losses incurred, special expenses, extraordinary expenses and allowances.⁷⁷

Neither of these definitions and, especially the OECD and the EStG perceptions of income, refer to economic concepts, such as residual profits. One might ask oneself why tax residual profits at all then? The question must go even deeper in asking how can it be justified that an economic concept, which, at a first glance, has no connection to income as understood in tax law, still be incorporated into tax law and lead to taxation?

The answer to these questions can only be found after analysing the notion of income in a tax perspective.

Under an optimal tax theory, the a taxpayer's ability to pay will determine the income tax he/she has to pay based on a fair assessment of what he/she can actually pay. This theory relies on a benchmark taxpayer that cannot be found in real life. Therefore, income taxation can only be successful (or even fair) if its basis is objectively quantifiable, *i.e.* if it is measurable instead of being based on a strictly defined benchmark. The lack of flexibility should, however, not be understood as a free ticket to taking a pragmatic approach to the determination of income. Rather, compromises should be sought by modifying the (on paper) optimal theory in a way that leads to a functioning system.⁷⁸

The purpose behind imposing taxes based on the ability to pay is to reallocate resources in order to achieve equality and fair distribution of such resources. In this regard, fairness and the ability to pay are closely linked when determining the taxable income of a taxpayer. What is perceived as being fair is, of course, a matter of perspective and more of a political than a tax-related question but, as is the case with income, compromises and flexibility can ultimately lead to greater fairness, and with that equality,⁷⁹ which is also one of the core principles of EU law.⁸⁰

Fairness in the context of income allocation has a vertical and a horizontal side to it. While vertical fairness seeks to achieve fair distribution by treating people in different income classes differently (*i.e.* application of a progressive tax rate), the horizontal dimension aims at ensuring that taxpayers in equal circumstances are treated equally. With that in mind, it would appear contrary to the concept of horizontal fairness, or equality for that matter, to exclude certain types of income from taxation. This would, equally, not be in line with the ability to pay because if some types of income are not taxed, this would allow taxpayers earning such income to escape taxes. Therefore, if it holds true that the ability to pay principle is able to reflect a fair tax system, each and every type of income has to be subject to tax.⁸¹

⁷⁶ OECD (2017), Tax on corporate profits (indicator); available at: <https://data.oecd.org/tax/tax-on-corporate-profits.htm>.

⁷⁷ §2 Abs. 2 EStG 1988, BGBl. Nr. 400/1988 idgF.

⁷⁸ K. Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (IBFD Publications, Doctoral Series, 2001), p. 9, 10.

⁷⁹ *Ibid.*, p. 14, 16.

⁸⁰ M. Helminen, "Concepts and Basic Principles of EU Tax Law" in *EU Tax Law – Direct Taxation*, Online Books IBFD (IBFD 2016), p. 9.

⁸¹ K. Holmes (n. 78), p. 21, 25, 26.

Returning to the definition of residual profits in economics, they constitute an additional return and can, therefore, be considered to have “tax-income like” characteristics, *i.e.* they are measurable and add to the ability to pay of a taxpayer. Since all income should be subject to taxation, it can, furthermore, be deduced that the economic concept of residual profits has found its way into the discipline of tax law and needs to be considered when determining the taxable income of a taxpayer.

As pointed out above, fairness and equality play a big role in the allocation and redistribution of profits. The following chapters will, therefore, concern themselves with how this allocation should take place, especially with regards to tax law in its entirety and not only in transfer pricing as one of its sub-disciplines.

VIII. Back to the Roots – The ALP as the Backbone of Transfer Pricing

8.1 Taking a Step Back – Why do We Need Transfer Pricing Legislation at All?

Originally, the intent of TP legislation was to prevent tax avoidance structures and to ensure that a taxpayer’s ability to pay was not artificially distorted. Income, for that matter, is used as a reliable indicator of a person’s tax paying power. At the same time, through calculated transfer pricing practices, income could easily be shifted amongst jurisdictions, effectively avoiding taxation. MNEs in particular, were able to abusively circumvent taxation being internationally present and not subject to market forces. TP legislation, consequently, was introduced to put a halt to tax avoidance and to ensure that each taxpayer carries the burden of taxation according to his actual ability to pay.⁸²

It should be noted, however, that the OECD TPG explicitly do not intend their suggestions to be rules of anti-avoidance, but that they are capable of being used in that context.⁸³ The original perception of TP rules has, furthermore, changed towards the question of fair income allocation.⁸⁴

Be that as it may, a connection between TP rules and tax avoidance is undeniable.

Based on Brauner’s statement that “*the arm’s length standard is the heart, spirit and foundation of the current international transfer pricing regime*”⁸⁵ and that the ALP remains the prevailing and, supposedly, most appropriate method to ensure the correct allocation of income among different jurisdictions,⁸⁶ the ALP will be examined more closely, especially in connection with intangibles.

⁸² L.E. Schoueri, “*Arm’s Length: Beyond the Guidelines of the OECD*” (2015), Bulletin for International Taxation, p. 690.

⁸³ OECD TPG (n. 4), p. 31 at 1.2.

⁸⁴ L.E. Schoueri (n. 82), p. 691.

⁸⁵ Y. Brauner, “*Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*” (2008), Virginia Tax Review, vol. 28, p. 96.

⁸⁶ L.E. Schoueri (n. 82), p. 691.

8.2 The Arm's Length Principle Revisited

Art 9 OECD MTC states that

“1. Where

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*

*and in either case conditions are made or imposed between the two 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”.*⁸⁷

Reading between the lines of this provision one will find that it encloses a separate entity approach and the ALP as underlying principles.⁸⁸

The ALP itself is used as a valuation standard in pricing matters involving associated enterprises, whereby it builds on comparability of the controlled and uncontrolled transaction. Application of this principle should, ideally, lead to a business environment in which shifting of income, as well as the erosion of tax bases and double taxation are prevented.⁸⁹

Whether this is the case, will be dealt with later on in this paper. But first, the purpose behind the ALP shall be considered.

8.2.1 The Idea behind the Arm's Length Principle

In order to ensure that affiliated and independent companies are treated in an equal manner, the ALP refers to market prices as a reliable means for comparing the situations of either type of company and to establish tax neutrality between them. The ALP, therefore, precludes MNEs from mispricing intra-group transactions and guarantees equal tax treatment of entities, irrespective of whether they are part of a group or stand for themselves. By preventing

⁸⁷ OECD MTC (n. 10), Art 9.

⁸⁸ OECD MTC Commentary, Commentary on Art 9, para 2.

⁸⁹ J. Wittendorff, *“The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?”* (2011), p. 225, 227.

mispricing of intra-group transactions, this principle also ensures equality amongst States with regards to the correct allocation of taxable income and the protection of their tax revenue.⁹⁰

Narrowing the ALP down to its core, the principle of equality (hidden behind the principle of ability to pay) reveals itself. Equality in a TP context can be achieved where the use of a defined proxy establishes, based on a certain criterion, that taxpayers are comparable.⁹¹

But what is comparability, really?

8.2.2 Comparability – Reality, Fiction or Non-existent?

Equality necessarily presupposes comparability meaning that equality between taxpayers can only be assessed and confirmed if facts and circumstances can be found allowing for a useful comparison to be made.

Market income (the proxy), for example, can be used as a comparable with which the ability to pay of different taxpayers can be determined. This, however, holds only true for independent transactions. In transactions between associated enterprises, profits merely represent the outcome of trade negotiations within the group. It is exactly these cases which require the application of the arm's length test, as it holds the potential to blow the cover of intra-group prices and establish the price under which the transaction should have actually taken place, *i.e.* the market price. In an optimal world, the conversion, by means of the arm's length test, of surreal prices to market prices leads to fulfilment of the principle of equality.⁹²

This, however, entails a fictional element, in the sense that controlled transactions are treated as if they had occurred under market conditions, and as such not considering the actual prices involved in the transaction, but arm's length prices.⁹³ The fiction under the ALP goes so far as to treat the different group members as independent, stand-alone entities. Hence, the allocation of profits among the different jurisdictions follows the separate entity approach.⁹⁴

Fiction does not, however, mean that any pricing scenario can be used. The ALP is dependent on comparability, which presupposes that intra-group transactions need to be identifiable. Additionally, there must be a corresponding comparable transaction on the market in which independent companies are involved, in order to test the transfer price against the arm's length principle.⁹⁵

The application of the ALP proves to be difficult, as a matter of fact, where intangibles are involved, mostly because of the lack of comparables and the high level of integration found within MNEs.⁹⁶

⁹⁰ X. Ditz, „Die Grenzen des Fremdvergleichs – Zugleich ein Plädoyer für ein Festhalten am Fremdvergleichsgrundsatz“ (2015), Finanzrundschau, p. 116.

⁹¹ L.E. Schoueri (n. 82), referring to Professor Humberto Avila's "theory of tax equality", p. 695.

⁹² L.E. Schoueri (n.82), p. 696.

⁹³ Ibid., p. 697.

⁹⁴ E. Baistrocchi, "The Transfer Pricing Problem: A Global Proposal for Simplification" (2005-2006), Tax Lawyer, vol. 59, no. 4, p. 944.

⁹⁵ X. Ditz (n. 90), p. 117.

⁹⁶ Final Report, (n. 5), p. 74 at 6.33.

Considering the ALP is supposedly the backbone of a successful transfer pricing analysis, it will not come as a surprise that critics have raised their voices against its application, and have come up with alternatives that do not rely on comparables.

The objections to the ALP and other possible methods will be subject to the remainder of this paper.

8.3 The Flaws of the Arm's Length Principle

8.3.1 The Inherent Flaw of the ALP

It is undisputed amongst scholars, be it proponents or opponents of the principle, that the ALP has its flaws. The criticism is based on a wide range of arguments. One critique focuses on the impossibility of dividing the international tax base, as a consequence of the failure to define the rationale of the ALP through feasible case law.⁹⁷

Another critical approach to the ALP argues that one might have to deal with cases in which comparables factually cannot exist. As an example, value deriving from common control, as a feature of MNEs, but by definition not of independent companies can never be tested against market conditions. Furthermore, there might be cases in which comparables are theoretically available, but the result of the comparison would lead to such a wide range of possible prices as to call the result of the arm's length test into question.⁹⁸

The ALP, lastly, is questioned with regards to its effectiveness in the sense that, absent comparables, the arm's length test creates inconsistent prices in its attempt to define a common concept of the principle.⁹⁹

All of these critiques relate to the application of the ALP itself, stigmatising it as "inherently flawed". In this sense, it is said to not mirror actual market conditions, *i.e.* economic reality, because the integrative character of MNEs might lead to synergy effects that cannot be taken into account under the ALP.¹⁰⁰ The Final Report acknowledges this problem by stating that comparability issues may arise in such cases. It further states that the benefits of deliberately constructed synergy effects should be divided between the contributing group-members, but does not give any specific guidance on how this should be done.¹⁰¹

Going into further detail on synergy effects is beyond the scope of this paper, and therefore the analysis of this particular topic will end here. A short conclusion on the inherent flaw of the ALP stemming from issues connected to group-synergies will, nevertheless, be given at this point.

⁹⁷ E.Baistrocchi (n. 94), p. 646, 951.

⁹⁸ M. A. Kane, "Transfer Pricing, Integration and Synergy Intangibles: A Consensus Approach to the Arm's Length Standard" (2014), World Tax Journal, p. 290.

⁹⁹ R.S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation" (2007), Public Law and Legal Theory Working Paper Series, Working Paper no. 92, p. 19.

¹⁰⁰ L.E. Schoueri (n. 82), p. 698.

¹⁰¹ Final Report (n. 5), p. 47 at 1.157 and 1.162.

Due to MNEs being by nature spread around the world, and deriving benefits from certain structures allowed by such international presence, they often choose to keep as many transactions as possible within the group instead of exposing them to market conditions. In this way, they create advantages for themselves that independent entities cannot reach, the effect of which is what is generally understood to be the inherent flaw of the ALP. As *Brauner* puts it, the ALP is “*attempting to compare the incomparable*”¹⁰² in its comparison between independent and compared transactions.¹⁰³

A second category of criticism of the ALP does not question the ALP itself but sees problems in its application. This will be discussed below, especially with reference to the PSM.

8.3.2 The Illusion of Comparability at the Core of the ALP

It cannot be said often enough that comparability is a major factor of a transfer pricing analysis. The ALP is constructed in such a way as to ensure that transactions between related companies occur under the same circumstances as would be the case if the parties were independent. According to some scholars, this assumption, however, only exists in an optimal transfer pricing world.¹⁰⁴ They claim that

*“[...] the problems with the current system do not derive from rules at its periphery, but instead from a fallacy that lies at the system’s central core: namely, the belief that transactions among unrelated parties can be found and that they can be used as meaningful benchmarks for tax compliance and enforcement”.*¹⁰⁵

The claimed fallacy has its origin in the markets in which MNEs operate which, in turn, generate TP issues, because of the unlikelihood of finding eligible comparables on these markets.¹⁰⁶

As a reaction to the lack of comparables, the use of profit split methods has become increasingly more important and, consequently, the application of the ALP has been questioned even more because it suddenly allowed an income allocation based on – what might be considered – a formulary approach.¹⁰⁷

Depending on whether one interprets the ALP in a stricter or a broader sense, it can either contain only those TP methods that rely on the use of comparables or can also include methods that do not compare transactions but only work towards a justifiable result, *i.e.* a result that would also be achieved in independent transactions.¹⁰⁸

¹⁰² Y. Brauner (n. 85), p. 108.

¹⁰³ *Ibid.*, p. 108.

¹⁰⁴ R.S. Avi-Yonah/I. Benshalom, “*Formulary Apportionment – Myths and Prospects*” (2011), *World Tax Journal*, p. 373.

¹⁰⁵ *Ibid.*, p. 376.

¹⁰⁶ *Ibid.*, p. 377.

¹⁰⁷ *Ibid.*, p. 382, 383.

¹⁰⁸ R.S. Avi-Yonah (n. 99), p. 4.

As mentioned before, regarding the choice of the correct TP method, the Transfer Pricing Guidelines ask for the most appropriate method applicable to the facts and circumstances at hand.¹⁰⁹

With this guidance in mind, and the fact that profit split methods do not rely on comparables, it can be argued that “*the redefinition of the ALS¹¹⁰ has been completed*”¹¹¹ because comparability no longer lies at the core of the ALP.¹¹²

In the following chapter, the PSM will be analysed in the light of the foregoing critical approach to the ALP.

IX. The Residual Profit Split Method Revisited¹¹³

9.1 A Short Recap of the PSM

As mentioned before, the OECD TPG suggest using the PSM for transactions in which either of the involved parties makes contributions of a unique character or of high value.¹¹⁴ In order to allocate income deriving from, for example, the exploitation of intangibles, the combined profits are allocated in two steps. In a first step routine contributions are compensated for at arm’s length after applying one of the traditional TP methods or the TNMM. Remaining profits, *i.e.* residual profits, are then divided between the affiliated companies based on certain allocation keys.¹¹⁵

As noted above, the critical point is how to determine the proportion to which the residual profits should be split based on the relative contributions each party has made to the transaction.¹¹⁶

The second step of the residual profit allocation method has been the subject of significant recent debate leading the OECD to take further action which, as of today, has resulted in the issuing of a public discussion draft concerning profit splits.¹¹⁷

9.2 Is the PSM Really Based on the ALP?

According to the TPG, yes.

¹⁰⁹ OECD TPG (n. 4), p. 59 at 2.2.

¹¹⁰ Note that in the United States the ALP is referred to as arm’s length standard (ALS).

¹¹¹ R.S. Avi-Yonah (n. 99), p. 24.

¹¹² *Ibid.*, p. 24.

¹¹³ Whenever the abbreviation ‘PSM’ is used in this chapter, reference is made to the residual profit split analysis.

¹¹⁴ OECD TPG (n. 4), p. 60 at 2.4.

¹¹⁵ *Ibid.*, p 97 at 2.121 and p. 101 at 2.134.

¹¹⁶ Gonnet/Fris (n. 71), p. 8.

¹¹⁷ OECD (2016), *Public Discussion Draft BEPS Actions 8-10 Revised Guidance on Profit Splits*, OECD Publishing (Discussion Draft).

They consider profit as relevant indicator, proving whether or not a controlled transaction has been mispriced.¹¹⁸ This is, of course, done by way of comparison between the intra-group transaction and an independent transaction. Since the comparison, however, does not have to be based on prices, profits can also be used and, just like that, the PSM is (all of a sudden) within the scope of the ALP.¹¹⁹

The Guidelines even go so far as to allow the application of the PSM where no comparables can be found or allow reliance on internal data.¹²⁰

The interpretation of the ALP (and comparability) in such a broad sense infers that the TPG accept the use of certain allocation keys which is, in essence, what formulary apportionment (see below) does. At the same time, the TPG explicitly state that the PSM differs from formulary apportionment in so far as the allocation keys are to be determined on a case-by-case basis, therefore keeping the PSM within the scope of the ALP.¹²¹

The PSM also differs from formulary methods in so far that, under the PSM, allocation concerns the profits from a single, controlled transaction, whereas formulary allocation includes the entirety of profits that the MNE has generated as a whole.¹²²

Critics of the ALP like to interpret the application of the PSM a little differently.

Avi-Yonah, for example, states that the PSM (and the TNMM) deviates from the traditional conception of comparability under the ALP. It can, therefore, be argued that the PSM is not based on the ALP. He goes even further by saying that if comparables are no longer a precondition in the application of the ALP then it cannot be said that any other method not relying on comparables is not in line with the ALP.¹²³

It is, further, argued that the ALP is superficial in so far as it applies the PSM (amongst others) “*under the umbrella of the arm’s-length principle*”¹²⁴ and that the OECD, by overlooking the requirement of comparability in an arm’s length analysis, has actually moved closer to profit allocation based on formulary apportionment.¹²⁵

In that regard, and because it is nearly impossible to determine where comparability (in its broad sense) under the ALP ends and formulary apportionment begins, it is argued that these two methods should no longer be seen as two extremes in transfer pricing, but rather as elements to a range of methods, reaching from the comparable uncontrolled price method to fixed formulas.¹²⁶

Given the arguments for and against the PSM being based on the ALP, and the conclusion that one cannot definitely deem the allocation of residual profits under the PSM to be contrary to Art 9 of the OECD Guidelines, the statement that the “*arm’s length principle is*

¹¹⁸ OECD TPG (n. 4), p. 77 at 2.57.

¹¹⁹ Ibid., p. 33 at 1.7.

¹²⁰ Ibid., p. 93 at 2.109 and p. 103 at 2.141.

¹²¹ J. Li (n. 14), p. 75; see also OECD TPG (n. 4), p. 37 at 1.18.

¹²² L.E. Schoueri (n. 82), p. 693.

¹²³ R.S. Avi-Yonah, “*Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*” (2010), World Tax Journal, p. 4, 5.

¹²⁴ B. J. Arnold/T. E. McDonnell, “*The Allocation of Income and Expenses Among Countries: Report on the Invitational Conference on Transfer Pricing*” (1993), 10 Australian Tax Forum, p. 553.

¹²⁵ R.S. Avi-Yonah (n. 123), p. 4.

¹²⁶ B.J. Arnold/T.E. McDonnell (n. 124), p. 554.

now slowly but surely being relegated to the back seat”¹²⁷ of transfer pricing should be viewed as inaccurate. Nevertheless, the question arises about which other options are available to allocate residual income in a fair manner.

The formulary apportionment method will be subsequently presented as an alternative to the ALP, before a conclusion will be drawn on which method might be the most appropriate – if there is one.

X. Formulary Apportionment

10.1 General Remarks

Formulary apportionment methods come in many different shapes and sizes. In the U.S., for example, global income is apportioned under a combined, unitary regime, whereas the Common Consolidated Corporate Tax Base (CCCTB) proposed by the European Commission takes a multi-factor approach. Under this approach, the entire income of EU resident group-entities is proportionally allocated based on fractions of sales ($\frac{1}{3}$), assets ($\frac{1}{3}$), payroll ($\frac{1}{6}$) and headcount ($\frac{1}{6}$).¹²⁸ FA might as well be based solely on sales, as Avi-Yonah and Clausing argue.¹²⁹ Some scholars differentiate between routine and residual profits¹³⁰ and others argue for a compromise between an ALP and FA approach.¹³¹

For the purpose of this paper, the differences between these approaches are not relevant, and will therefore not be examined in detail. It is, instead, sufficient to present the general principles of FA.

10.2 The Concept of Formulary Apportionment

Contrary to the TP methods mentioned in the TPG, formulary apportionment (FA) does not allocate profits according to the ALP. Instead, FA allocates profits by means of a predetermined formula based on factors like location of sales, property or payroll. These factors do not necessarily have to be of same weight in the formula. Nor need all of the factors be included. This method is, consequently, contrary to Art 9 of the OECD MTC.¹³²

¹²⁷ R. Robillard, “BEPS: Is the OECD Now at the Gates of Global Formulary Apportionment?” (2015), Intertax, vol. 43, issue 6 & 7, p. 447.

¹²⁸ J. Andrus/P. Oosterhuis, “Transfer Pricing After BEPS: Where Are We and Where Should We Be Going” (2017), Taxes – The Tax Magazine, Wolters Kluwer, p. 96.

¹²⁹ R.S. Avi-Yonah/K. Clausing, “A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project” (2007), Law & Economics Working Papers Archive: 2003-2009, art. 70.

¹³⁰ See for example: R.S. Avi-Yonah/K.A. Clausing/M.C. Durst, “Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split” (2009), Florida Tax Review, vol. 9, no. 5.

¹³¹ See for example: R.S. Avi-Yonah/I. Benshalom (n. 104).

¹³² H.-K. Kroppen/R. Dawid/R. Schmidtke, “Profit Split, the Future of Transfer Pricing? Arm’s Length Principle and Formulary Apportionment Revisited from a Theoretical and a Practical Perspective” in W.

The application of FA is conducted in three steps. The first step consists in determining the group members (subsidiaries and branches) that represent the MNE in its entirety. The following step accumulates the globally made profits of each of the subsidiaries and branches. The global profit is then, in a last step, allocated to each of the group members according to a certain formula.¹³³

FA therefore does not operate on a single-entity approach, as the ALP does, but accumulates all group members under the MNE, and treats the MNE as a whole as the taxpayer.¹³⁴ In other words, the existence of several entities within the MNE is ignored, to the effect that the profits made by the group are treated as if a single, non-affiliated entity had generated them.¹³⁵

Establishing an FA system, however, has two shortcomings from the outset. First, the definition of the “unitary business” appears to be problematic, since the perception regarding which of the affiliated entities actually is part of the unitary business varies amongst the States.¹³⁶

Second, and this is one of the major arguments against FA, a common formula, *i.e.* which factors the formula should include, would need to be agreed upon amongst the States.¹³⁷ The difficulty in finding consensus on the formula is obvious: each State will want to include only those elements that are advantageous for itself and they will not all be the same.¹³⁸

The foregoing chapter on the PSM and this chapter on FA gave a short overview on the problems each of these methods face.

The next chapter will proceed to present arguments for and against each of these methods and try to establish which is the preferable one.

Even if the analysis comes to the conclusion that neither of the methods is preferable to the other, a decision still has to be made. This eventuality will also be given attention to in the following chapter.

XI. The Final Show Down – FA v. ALP

11.1 General Remarks

As the ALP is currently the predominant method of profit allocation, the “final show down” will begin with arguments in favour of FA since, if it wants to prevail, it will have to

Schön/K. Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer 2011), p. 273.

¹³³ Ibid., p. 273.

¹³⁴ R.S. Avi-Yonah (n. 99), p. 3.

¹³⁵ M.T. McIntyre, “*Design of A National Formulary Apportionment Tax System*” (1991), Proceedings of the Annual Conference on Taxation Held under the Auspices of the National Tax Association-Tax Institute of America, vol. 84, p. 119.

¹³⁶ R.S. Avi-Yonah (n. 99), p. 27.

¹³⁷ M.T. McIntyre (n. 135), p. 121.

¹³⁸ Ibid., p. 27.

convincingly stand its ground against the already established ALP. It will then be the ALP's turn to rebut any arguments that could justify its replacement in transfer pricing.

11.2 Round 1 – FA on the Rise

11.2.1 Synergies and Comparability no Longer Matter

As mentioned above, the ALP is not capable of (fully) taking synergy effects into account (see 8.3.1, above). As FA methods do not rely on a comparison of transactions but only focus on the overall made profits, they indirectly take account of internal value-chains without explicitly considering (or comparing) the transactions happening within a group.¹³⁹

With regards to intangibles, the fact is that comparables are nearly impossible to find. The lack of suitable comparables is a result of the MNEs' preference to enter into transactions with related parties which, in turn, decreases the number of potentially comparable independent transactions. In other words, the transactions between affiliated companies are utterly distinct from external transactions and can therefore not be compared with each other. In this regard, FA seems to represent a suitable alternative since it does not require comparables.¹⁴⁰

11.2.2 FA is no More Arbitrary than the ALP and Ensures State Revenues

FA is often criticised for being arbitrary, because the factors used in the formula can only approximately allocate profits to the jurisdictions in which activities are performed. As a result, relying on an average allocation (deriving from the application of the formula) of profits is contrary to profits being taxed where they are generated, *i.e.* in the source jurisdiction.¹⁴¹

Proponents of the FA admit that this method is arbitrary, but argue that it is no more arbitrary than the ALP, which relies on fictions by referring to market transactions that do not reflect how MNEs actually conduct intra-group transactions.

Contrary to the ALP, however, FA methods are more predictable when it comes to generating revenues, because contractual arrangements of MNEs are less likely to have an effect on a formula and are therefore not as easy to tamper with.¹⁴² FA would even decrease the MNEs' incentive to shift profits among jurisdictions because it focuses on world wide income anyway. In that regard, it would make no difference where income is "physically" present, and the respective States' revenue would be saved.¹⁴³

¹³⁹ L.E. Schoueri (n. 82), p. 700.

¹⁴⁰ M. Markham, "Transfer Pricing of Intangible Assets in the US, the OECD and Australia: Are Profit-Split Methodologies the Way Forward?" (2004), University of Western Sydney Law Review, vol. 8, p. 74, 76.

¹⁴¹ R.S. Avi-Yonah/I. Benshalom (n. 104), p. 381.

¹⁴² *Ibid.*, p. 382.

¹⁴³ R.S. Avi-Yonah/K.A. Clausing/M.C. Durst (n. 130), p. 507.

11.2.3 FA is Simpler and Less Costly than the ALP

Under an FA-regime it would no longer be necessary to ascribe certain income to certain jurisdictions which, in turn, eliminates compliance burdens and costs. All that needs to be done is to determine the unitary business, and to then apply the formula for profit allocation.

The application of the formula also makes extensive documentation of transactions obsolete, which will ultimately lead to cost-savings for the companies.¹⁴⁴ The costs MNEs incur are both of public and private nature and can be traced back to the ALP, in so far as MNEs consult lawyers, economists and accountants in ensuring they do not misprice intra-group transactions.¹⁴⁵

11.3 Round 2 – The ALP Strikes Back

11.3.1 The ALP and Transfer Pricing as Part of a Bigger Picture

While it is true that the ALP cannot consider synergy effects and has its limits as regards comparability one must not forget that the ALP, and transfer pricing as such, are part of a bigger picture, namely (international) tax law.

Within the EU it is, additionally, subject to the fundamental principles of EU law amongst which the principle of equality can be found.¹⁴⁶

As already mentioned, the ALP intends to create equality between dependent and independent companies.¹⁴⁷ It does so by comparing market prices to “MNE prices”, to ensure that MNEs cannot obtain any tax advantages, in the sense that the positions of the single group-entities on the market cannot effectively be manipulated.¹⁴⁸

Generally speaking, TP legislation has the purpose of

*“re-establishing equality among taxpayers by allocating income according to their ability to pay, irrespective of their power to influence the prices of controlled transactions”.*¹⁴⁹

Ability to pay is a corner-stone principle of tax law¹⁵⁰ and stands in close relation to the principle of equality.¹⁵¹ Equality, subsequently, is established by comparison of similar circumstances.¹⁵²

¹⁴⁴ R.S. Avi-Yonah/K. Clausing (n. 129), p. 16-18.

¹⁴⁵ E. Escribano, “*Is the OECD/G20 BEPS Initiative Heading in the Right Direction? Some Forgotten (and Uncomfortable) Questions*” (2017), Bulletin for International Taxation, p. 254.

¹⁴⁶ M. Helminen (n. 80), p. 9.

¹⁴⁷ L.E. Schoueri (n. 82), p. 695.

¹⁴⁸ OECD TPG (n. 4), p. 33,34 at 1.7 and 1.8.

¹⁴⁹ L.E. Schoueri (n. 82), p. 695.

¹⁵⁰ F. Vanistendael, “*Ability to Pay in European Community Law*” (2014), EC Tax Review, vol. 3, p. 121.

¹⁵¹ C. Bardini, “*The Ability to Pay in the European Market: An Impossible Sudoku for the ECJ*” (2010), Intertax, vol. 38, issue 1, p. 2.

¹⁵² L.E. Schoueri (n. 82), p. 696; emphasis added.

This is exactly where the argument that FA gets along without the search for comparables (see 11.2.1, above) gets crushed. It might be true that for TP purposes this supposed strength of FA appears to be practical, but in the wider context of international tax law FA methods cannot be accepted as they completely disregard the “ability to pay” principle as one of the guiding principles of tax law.¹⁵³

In that regard, the ALP also fits better with the tax law’s concept of income as established above in the discussion of whether residual profits actually need to be considered with regards to income taxation.

In terms of synergies, attention should be drawn to the economic ramifications of applying FA methods. If internal transactions are taken into account, and the overall profits are distributed between various jurisdictions, profits and losses are not considered in the States in which the economic activity occurs. This fact is not just another piece of evidence that FA ignores fundamental principles, but also implies that FA is arbitrary.¹⁵⁴ While the ALP is also arbitrary to some extent¹⁵⁵, it is an effective tool in allocating income to jurisdictions, rather than only to the various members of the group, thereby protecting national tax bases.¹⁵⁶ Formulary Apportionment, on the other hand, uses formulas detached from any “market reality”, which is against the *rationale* of TP.¹⁵⁷

11.3.2 FA is Simpler and Less Costly than the ALP

The arguments in favour of FA mentioned above (see 11.2.3) cannot be denied.

The conclusion that must be drawn from the foregoing analysis, however, is that in the big picture of tax law, the application of the ALP appears to be more justified, since it is based on market prices which, in the end, ensure equality by applying international tax norms in a similar manner to both intra-group and unrelated transactions.¹⁵⁸

11.4 What About Intangibles?

The attentive reader will realise during the weighing of the pros and cons of both the ALP and FA, intangibles were not mentioned. This is simply because neither of the methods can give a satisfactory answer on how to allocate residual profits deriving from intangibles. This shall, however, not be the final conclusion to this paper.

¹⁵³ L.E. Schoueri (n. 82), p. 700.

¹⁵⁴ R.S. Avi-Yonah/I. Benshalom (n. 104), p. 381.

¹⁵⁵ See for example: W. Schön “*International Tax Coordination for a Second-Best World (Part III)*” (2010), World Tax Journal.

¹⁵⁶ *Ibid.*, p. 230.

¹⁵⁷ L.E. Schoueri (n. 82), p. 695.

¹⁵⁸ Y. Brauner, “*Formula Based Transfer Pricing*” (2014), Intertax, vol. 42, issue 10, p. 626.

It has already been established that both the ALP and FA are somewhat arbitrary. What FA falls short of is that its formulas generally do not include intangibles. Risks are, furthermore, not considered in formulaic approaches. In contrast, both of these factors are of considerable weight to the BEPS project and transfer pricing as such.¹⁵⁹

In that regard, FA is an easier applicable method but might lead to a distorted reflection of how much income was generated in each State, not least because it simply ignores the problems connected with valuating intangibles.¹⁶⁰

Even in cases in which intangibles are included into the formulas using costs as well as sales factors of intangibles in order to determine how much profit they contribute to a business, the difficulty to allocate them to the right jurisdiction remains.¹⁶¹

Relying on the residual profit split method, similarly, has not led to satisfying results; especially considering the effect it has on the ALP as a basic principle of transfer pricing.

The OECD is aware of the problems the PSM has caused lately, and has gone as far as to admit that further guidance will be necessary on the when and how of applying the PSM.¹⁶² As of today, the OECD has issued a revised guidance on profit splits, in the form of a public discussion draft, in which it seeks clarification on the application of the PSM in general and searches for answers to particular questions.¹⁶³

Since the OECD refuses to accept FA as an alternative¹⁶⁴ to the transfer pricing methods it suggests and any attempt to replace the ALP by FA would, without doubt, bring with it, as Avi-Yonah puts it, a “*complicated process of trial and error*”¹⁶⁵ it might be reasonable, for now, to stick with the transfer pricing system as it stands.

This seems even more reasonable under the light of the consequences a change would have if consensus on a formula will ever be met. A major factor to consider is the impact a change would have on double tax conventions, which are based on the ALP. Double taxation, for example, will be an inescapable consequence.¹⁶⁶

Having said that, the final part of the analysis will focus on the Discussion Draft and the possible improvements it might add to the TPG in terms of the profit split method.

¹⁵⁹ G. Cottani, “*Formulary Apportionment: A Revamp in the Post-Base Erosion and Profit Shifting Era?*” (2016), *Intertax*, vol. 44, issue 10, p. 756.

¹⁶⁰ J. Roin, “Transfer Pricing in the Courts: A Cross-Country Comparison” in W. Schön/K. Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer 2011), p. 193.

¹⁶¹ J. Li, “*Global Profit Split: An Evolutionary Approach to International Income Allocation*” (2002), *Canadian Tax Journal*, vol. 50, No. 3, p. 849.

¹⁶² Final Report (n. 5), p. 55.

¹⁶³ Discussion Draft (n. 117).

¹⁶⁴ OECD TPG (n. 4), p. 38 at 1.21.

¹⁶⁵ R.S. Avi-Yonah/I. Benschalom (n. 104), p. 391.

¹⁶⁶ X. Ditz (n. 90), p. 119.

11.5 The Discussion Draft on Profit Splits

11.5.1 The PSM as Most Appropriate Method

In figuring out whether or not the PSM is most suitable for the case at hand, focus should be put on the economically significant risks associated with the controlled transaction. Should it emerge that the parties concerned share such risks, the PSM can be considered as the most appropriate method. Note that the risks do not have to be of the same kind, as long as they are in close connection to each other.¹⁶⁷

In that regard, it is important to differentiate between economically significant risks that relate to a specific controlled transaction and such risks that are related to the entity as such. The Discussion Draft clarifies that a PSM can only be applied where economically significant risks associated with the controlled transaction are concerned.¹⁶⁸

Under these conditions, a limit is set to the circumstances under which the PSM might be the most appropriate method and, thereby, the risk of overusing it has been diminished.¹⁶⁹

11.5.2 Value Chain Analysis

The Discussion Draft aims to establish the conditions under which the application of the PSM is actually the most appropriate method. In the course of this guidance a new subsection entitled “value chain analyses” is introduced.¹⁷⁰ The value chain analysis is used as a means to accurately delineate the controlled transaction and should help to establish whether or not the PSM should be applied to the case at hand. The Draft explicitly mentions, in that regard, that the mere fact that an MNE conducts its business based on a value chain does not automatically imply that the application of PSM is justified.¹⁷¹

The Discussion Draft clearly tries to limit the application of the PSM to specific circumstances, in order to rebut the assumption that formulary apportionment might be an applicable allocation method, or, for that matter, that the PSM is a form of FA. In that sense, the value chain analysis is meant to assist in accurately delineating a transaction, instead of calling for the application of a PSM just because a value chain was identified.¹⁷²

11.5.3 Limitation of the PSM to Specific Circumstances

The Discussion Draft, further, clarifies that a PSM might constitute the most appropriate method only in cases in which the activities performed by the parties are highly

¹⁶⁷ Discussion Draft (n. 117), p. 8, para 16.

¹⁶⁸ Ibid., p. 8, para 17.

¹⁶⁹ R. Petruzzi/C. Peng, “*The Profit Split Method: Historical Evolution and BEPS Insight*” (2017), Transfer Pricing International, p. 48.

¹⁷⁰ Discussion Draft (n. 117), p. 11.

¹⁷¹ Ibid., p. 11, paras 24, 25.

¹⁷² A. Shapiro/E. Kuo/A. Chakravarty, “*Applying the profit split method*” (2017), International Tax Review, p.1, 2.

integrated and in situations in which more than one group member makes valuable and unique contributions.¹⁷³

An operation qualifies as being highly integrated where the functions performed, assets used and risks assumed by one party are so closely connected to those of another party that they cannot accurately be separated from each other.¹⁷⁴

In terms of integration, sequential and parallel integration can be distinguished. A PSM will most likely only be appropriate, as a matter of fact, in cases of parallel integration, because this kind of integration does not produce the possibility of finding reliable comparables as different parties add value to intangibles in the same stage of the “production process”. The delineation of the transaction might then reveal that all the parties assume a significant amount of economical risks, making a split of profits the best applicable method.¹⁷⁵

As far as unique and valuable contributions are concerned, the Discussion Draft clarifies that such cases would encompass contributions that are not comparable to those made by independent entities in similar circumstances, and whose use will be key in generating benefits of an economic sort.¹⁷⁶ At the same time, it stresses that the fact that no suitable comparables can be found does not mean that the PSM is the most appropriate method. Instead, it leans towards favouring adjustments and interpretation in cases where the risk assumption between the parties is not shared in the sense of being “economically significant”.¹⁷⁷

This suggestion could be considered as putting less weight on the comparability-factor in situations where one of the parties assumes a low level of risks. Furthermore, it might also be seen as implying that, by interpreting inexact but comparable pieces of information, the absence of comparables can be overlooked. The Discussion Draft justifies this solution by stating that, although the use of inexact comparables will probably not create satisfying results, they are still more likely to lead to an arm’s length outcome compared to the result produced by the PSM.¹⁷⁸

11.5.4 Improvements Achieved Through the Discussion Draft

The guidance given in the Discussion Draft hints towards the arm’s length principle still being the benchmark for transfer pricing. The PSM can, however, no longer be seen as the go-to method for the valuation of intangibles and, through the clarifications made with regards to the application of the PSM, this method now seems to be more in line with the ALP,¹⁷⁹ both because the Discussion Draft shaped the PSM towards a method that takes into account all of the facts and circumstances of a given transaction and because it is aimed at analysing the commercial and financial connections between the parties on a case by case basis. The use of

¹⁷³ Discussion Draft (n. 117), p. 9, para 19.

¹⁷⁴ Ibid., p. 9, para 19.

¹⁷⁵ Discussion Draft (n. 117), p. 9, para 21.

¹⁷⁶ Ibid., p. 10, para 22.

¹⁷⁷ Ibid., p. 8, para 18.

¹⁷⁸ Ibid., p. 8, para 18; see also: R. Petruzzi/C. Peng (n. 169), p. 49.

¹⁷⁹ A. Shapiro/E. Kuo/A. Chakravarty (n. 172), p. 3.

a value chain analysis and functional analysis (as element of the ALP) also imply that the PSM accords to the ALP.¹⁸⁰

The Discussion Draft, however, does not solve all outstanding issues. Uncertainties might remain with regards to the scope of “unique and valuable” intangibles, or on how “economically significant risks” are defined when assessing whether risk assumption is economically significant.¹⁸¹

Conclusion

This paper had as its purpose the examination of the difficulties arising from the allocation of residual profits deriving from intangibles. Therefore, in the course of the analysis basics of transfer pricing and the special considerations to be made with regards to intangibles were presented. The result of this basic introduction was that comparability lies at the heart of the ALP, but that comparability appears to be scarce in transactions involving intangibles. The lack of suitable of comparables stems from the unique character that intangibles have and that, given that they add considerable value to MNEs, intangibles are kept within the group to create market advantages.

Before an analysis of which method should be applied when allocating profits could be made, it had to be established that, although residual profits are of purely economic nature, they still have a place in tax law as they constitute something that has been realised and can therefore be subsumed under the concept of income.

It was then pointed out that, absent comparables, the profits split method has established itself as the go-to means to allocate profits amongst the group-members participating in the controlled transaction. This caused, however, significant controversy, since it has been claimed that the PSM stretched, or even ignored the ALP, in so far as it does not rely on comparables and therefore rather resembles formulary apportionment than a method compatible with the arm’s length principle; or even Art 9 of the OECD MTC more generally. Proponents of FA took this opportunity to promote the formulaic approach as a better method to allocate income amongst the different jurisdictions. With its one-entity approach and predetermined formulas, applied to the overall profit, FA, however, is contrary to the TP system as we know it at the moment.

The OCED is, nevertheless, aware of the flaws the ALP brings with itself, especially when it comes to the allocation of residual profits deriving from intangibles, and dedicates considerable efforts towards providing further guidance on how this topic should be dealt with.

The Discussion Draft issued in 2016, is the latest piece of (not yet accepted) guidance on how, and especially when, profit split methods should be applicable. The purpose of this guidance is to determine (and limit) the application of the PSM. In doing so, it focuses on the accurate

¹⁸⁰ R. Petruzzi/C. Peng (n. 169), p. 51.

¹⁸¹ M. Peggs, “A New Way To Do The Splits: B.E.P.S. Guidance Falls Short Of Enabling Global Formulary Apportionment” (2016), Insights, vol. 3, no. 7, p. 14; available at <http://publications.ruchelaw.com/news/2016-08/InsightsVol3no07.pdf>.

delineation of the controlled transaction, by introducing the value chain analysis as a supplementary tool to the functional analysis. Further, the notion of economically significant risks is described with more precision, to the effect that the PSM can only be considered as most appropriate method where the concerned parties assume the relevant risks to an equal extent.

In clarifying and adding these points, the Discussion Draft emphasises that the PSM adheres to the ALP and cannot be considered as a formulary method. This is especially so, because the PSM is applied on a case by case basis, allowing it to consider the special conditions of each transaction. Further, although the mode of its application is determined ex ante, it does not apply a one-fits-all fixed formula, as FA does.

All in all, it has to be concluded that the ALP is still to be seen as the preferred method of profit allocation as it fits better with the overall picture of international tax law.

The ALP (in its “Discussion Draft version”), however, cannot be seen as the solution to all the problems of (residual) profit allocation. Especially with regards to intangibles, it remains difficult to definitely allocate and value them in a way that would allow for profits to be taxed where they actually arise. The author is in serious doubt on whether this can ever be achieved but, after having engaged herself with the allocation of residual profits deriving from intangibles, is of the opinion that the ALP should, at least for now, remain as the benchmark for any transfer pricing analysis.

At the same time, the author is of the opinion that the allocation of residual profits deriving from intangibles as proposed by the Discussion Draft, still has its flaws and will certainly keep the discussion between proponents of the ALP and FA very lively. However, just as with finding the “optimal” income tax base, flexibility and the willingness to engage into compromises seems the right path to finding better solutions, which is why the author cannot take a definite position towards supporting either the ALP or FA.

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