

Oddleif Torvik

Transfer Pricing and Intangibles

US and OECD Arm's Length
Distribution of Operating Profits
from IP Value Chains

IBFD DOCTORAL SERIES

45

Transfer Pricing and Intangibles

Why this book?

The transfer pricing of intangibles (patents, trademarks, etc.) is an important issue in international tax law, because it determines how superprofits generated by multinationals through the exploitation of valuable intellectual property (IP) in their worldwide value chains are allocated among the jurisdictions in which they do business. For decades, multinationals have used IP transfer pricing to shift taxable profits out of high-tax jurisdictions, causing serious base erosion. Both the United States and the OECD seek to combat these practices through mandatory transfer pricing rules aimed at ensuring that IP superprofits are taxed where the intangible value was created. The profit allocation process prescribed by these rules is analysed in this text. The first part of the process determines the amount of superprofits allocable to a unique and valuable IP (royalty amount). The US and OECD transfer pricing methods that govern this determination are analysed, applying a distinction between unique and non-unique value chain contributions, and it is observed that the methodology has evolved significantly over the years, from primarily relying on imprecise third-party benchmarking to more substance-based approaches that seek to ensure results that adhere to the realistic alternatives of the controlled parties. The second part of the profit allocation process determines to which group entity, and thus indirectly also to which jurisdiction, the amount of IP superprofits will be allocated. The US and OECD intangible ownership provisions that govern this determination are analysed, applying an original analytical distinction between manufacturing and marketing IP. The analysis shows that, while both the US and OECD rules go a long way towards aligning the allocation of superprofits from R&D-based manufacturing IP with value creation, the allocation of superprofits from marketing IP still largely hinges on formal legal ownership and thus opens the opportunity for tax planning from multinationals and should be ripe for future reform. This book is suited for those that have an interest in transfer pricing analysis, e.g. students, lawyers, accountants and economists. The historical background of the current transfer pricing rules is explained, allowing for an “all-in-one” solution for catching up with the US and OECD transfer pricing development over the last decades.

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Preface

The research project that resulted in this book commenced in September 2011, when the author began his studies for the PhD programme at the Faculty of Law of the University of Bergen (UiB). The project was made possible by financing provided through a PhD research scholar position at the Department of Accounting, Auditing and Law (IRRR) at the Norwegian School of Economics (NHH). The project was initially intended to be finalized in September 2015, when my position at NHH ended. As life would have it, however, this was around the time that the US tax authorities issued relevant new regulations and just before the OECD finalized its BEPS deliverables on transfer pricing of intangibles and related topics in October 2015. The author found withholding the thesis until he could fully incorporate these developments to be the only rational solution. The thesis was submitted for evaluation at the Faculty of Law at UiB on 3 May 2016 and was defended on 9 December 2016. This book is an updated, and somewhat edited, version of that thesis. The text takes into account material published before 31 March 2018 (the date on which the text was submitted for publication).

The author's research has benefited from the input of many. When he began working as a tax lawyer in Oslo after his studies in 2006, he found it inspiring to observe how those he worked under mastered the tax law discipline, including, in particular, tax lawyer and Professor Arvid Aage Skaar and tax lawyer Terje Hoffmann, both with Wiersholm then, and tax lawyers Christian Bruusgaard, Sverre Koch and Henning Naas, all with Thommesen then. In this sense, they have contributed to the author's research, as there perhaps would be none without their inspiration. The author thanks the resources at IRRR, where he had his daily workplace throughout the project. He also thanks Professor Katarina Kaarbøe and Professor Guttorm Schjelderup at the Norwegian Centre for Taxation (NoCeT), for believing in the project and offering strong initial support; Professor Trond Bjørnenak, Professor Kjell Henry Knivsflå and Professor Frøystein Gjesdal for management accounting, valuation and transfer pricing discussions, respectively; Assistant Professor Dirk Schindler for insights on the economics of profit shifting; and PhD candidate Kjell Ove Røsok for financial accounting insights.

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2013 EATLP Poster Program for Doctoral Students in Lisbon and the 2014 IFA Mumbai Congress Poster programme, respectively, and would also like to thank everyone who engaged in discussions with him there. The author made several trips to the OECD in Paris throughout the project, participating in discussion draft consultations. He thanks those who shared their knowledge with him there, in particular Arthur Kristoffersen, Trude Sønvisen and Stig Sollund, with the Norwegian Ministry of Finance, and Matthew Wall, with MDW Consulting in Canada. The author also participated in several PhD seminars. At a 2012 seminar at BI Norwegian Business School in Oslo, Professor Ole Gjems-Onstad offered helpful comments at an early stage. At a 2013 seminar arranged by the Nordic Tax Research Council, the author learned from a lecture held by tax lawyer PhD Andreas Bullen. At a 2013 David Doublet seminar in Solstrand, Professor Ragna Aarli at UiB provided the author with helpful guidance. At a 2014 seminar at the Uppsala Center for Tax Law, the author benefitted tremendously from the vast international tax law insights of Professor Hugh J. Ault from Boston College Law School and from discussions with Professor Bertil Wiman and Associate Professor Jérôme Monsenego, both with Uppsala University. The author participated in several seminars arranged by the International Bureau of Fiscal Documentation (IBFD) in Amsterdam. He thanks those who engaged in discussions with him there, in particular Antonio Russo, with Baker & McKenzie, and Patrick Ellingsworth, trustee of IBFD. The author thanks NHH, NoCeT and the Meltzer Research Fund for financial contributions for making these research travels possible.

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He further thanks his mother, Ingvild, for her kind support throughout the entire project.

He dedicates this work to his beloved daughter, Kamille:

Denne boken er til deg, Kamille. Bestevenna for alltid.

Oddleif Torvik
Førde i Sogn og Fjordane, 31 March 2018

The author will be thankful for comments or questions on the book and can be contacted by email at oddleif.torvik@nhh.no.

Sample Content

Chapter 1

Research Questions, Methodology and Sources of Law

1.1. Introductory comments

Multinational enterprises are profitable. They make and sell products and services in multiple geographical markets. Behind the profits realized from selling a product in one particular jurisdiction may lie contributions from group companies resident in other countries or permanent establishments (PEs) of such companies in source jurisdictions. These different taxable entities within the multinational enterprise are all part of the same economic totality and do *not* have conflicting economic interests. Their contributions are priced, thereby effectively extracting profits from the jurisdiction where the product is sold. These controlled prices may deviate from those that would have been yielded by the normal supply-and-demand market mechanism that ensures balanced pricing among third parties with conflicting interests.¹ Most jurisdictions have, for this reason, enacted mandatory profit allocation rules that govern how a multinational must distribute its profits among its entities and have entered into tax treaties, which, also via profit allocation rules, ensure that there is no double taxation on such profits.²

This book is a study of how the profits from multinationals' sales of products and services based on unique intangibles (valuable patents, trademarks, etc.) are allocated among jurisdictions under two of the most significant and influential transfer pricing systems in the world:³ (i) the transfer pricing regime under US law under section 482 of the Internal Revenue Code (IRC); and (ii) the transfer pricing regime under articles 7 and 9 of tax treaties based on the OECD Model Tax Convention on Income and on Capital (OECD MTC).

There are important interactions between the two regimes. First, both are based on the same meta-norm, i.e. the arm's length standard, aimed

1. Or, as stated in Schön (2010a), at p. 236, “[B]etween independent taxpayers, transaction prices therefore truly allocate income.”

2. Schön (2010a), at p. 232, applies the terminology “transfer pricing control”, which conveys the purpose of such mandatory profit allocation rules well.

3. See Schoueri (2015) for principal reflections on the arm's length principle. See Schön et al. (2011), at pp. 47-67, for an insightful overview of the concept of transfer pricing across different legal contexts.

at achieving parity in the taxation of related and unrelated enterprises.⁴ Second, the overarching legal structure of the systems is similar. The basic principle for profit allocation is expressed in a few sentences in IRC section 482 and articles 7 and 9 of the OECD MTC and elaborated in the comprehensive section 482 of the US Treasury Regulations and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TPG). Third, even though the main principles for profit allocation under the two systems have remained intact since the first part of the 20th century, the more specific methodology that is decisive for the actual allocation of profits among jurisdictions is constantly evolving, with revisions typically aimed at avoiding base erosion and profit shifting (BEPS). Fourth, the systems are largely self-contained. Their allocation of intangible profits generally do not depend on underlying private law classifications. Fifth, there have historically been significant “spill-over” effects of the US regime on the OECD TPG. For instance, central TPG concepts, such as the transactional net margin method (TNMM) and the periodic adjustment authority, are more or less direct imports from US law.

The division of taxing rights among jurisdictions under both systems is effectively carried out through these profit allocation rules. The United States will tax the amount of profits from controlled transactions calculated pursuant to section 482 of the US Treasury Regulations. Indirectly, these rules also determine the amount of profits that the residence jurisdiction of the *other* group entity involved in the controlled transaction may tax without resulting in double taxation, disregarding tax treaties. Similarly, under article 9(1) of the OECD MTC, the amount of business profits from controlled transactions calculated pursuant to the OECD TPG may be taxed by the residency jurisdiction of the relevant group entity, while the residence jurisdiction of the *other* group entity involved in the controlled transaction shall, in principle, exclude an identical amount from taxation under article 9(2), thereby avoiding economic double taxation.

4. See Brauner (2016), at p. 108, where a background is provided through these fitting words: “There is no inherent justification for treating related and unrelated transactions alike beyond simplistic symmetry. One could have perhaps made an efficiency-based justification for such symmetry in some circumstances; however, such a case has not been made, and the arm’s length transfer pricing rules hardly follow efficiency goals. Arm’s length, therefore, is not a principle; it is a standard. It serves as a basis for the specific rules that implement it and is justified by other principles. In the case of arm’s length, it is justified as a method for allocation of profits. Even we know that, historically, it was one of several standards that could be used for achieving the goals that underlie our tax systems. It is perhaps the most desirable standard, yet it is not a principle”.

The same basic system, even though operationalized through a different legal mechanism,⁵ is put in place to govern the distribution of taxing rights to business profits among residence and source jurisdictions in the context of PEs under article 7(2) of the OECD MTC, according to which the profits allocated to the source jurisdiction pursuant to the OECD TPG and the 2010 OECD Report on the Attribution of Profits to Permanent Establishments (2010 OECD Report) shall be excluded from taxation in the residence jurisdiction through the provision of double taxation relief, thereby avoiding juridical double taxation.

This book is an analysis of the following two research questions:

- (1) The *primary* question is how the taxing rights to operating profits from intangible value chains shall be allocated among jurisdictions under IRC section 482 in US law and articles 7 and 9 of tax treaties based on the OECD MTC.
- (2) The *secondary* question, which is dependent on the results from the analysis of the primary research question, is to provide a critical assessment of whether the current US and OECD profit allocation solutions are useful or if they ideally should be altered, and if so, to propose the relevant amendments.

The author will further develop the research questions and outline the structure of the book in section 1.3., after introducing key terminology and providing necessary contextualization for the research questions in section 1.2.

This book will not address possible alternatives to arm's length transfer pricing, e.g. so-called "formulary apportionment" (distribution of worldwide operating profits based on predetermined allocation keys).⁶ Arm's length transfer pricing *is* the international consensus for profit allocation. It does not seem realistic that this will change in the near future. Analytical efforts therefore seem better spent contributing to legal clarification of the current regime rather than discussing more loosely based notions of possi-

5. For a multinational's tax planning purposes, an art. 9 allocation may yield a more favourable profit allocation, in the sense that double taxation relief is not contingent on the extent to which the profits are actually taxed in the other residence jurisdiction, much akin to the result of the exemption method under art. 7 (*see* art. 23A). This stands in contrast to an art. 7 allocation, where relief nowadays tends to be provided through the credit method (*see* art. 23B) and thus is contingent on the extent of taxation in the source state (of course, the exception method is still applied in some treaties).

6. For a recent overview of the features of formulary apportionment, *see* Andrus et al. (2017), at p. 96; and Pankiv (2017), at pp. 38-42. For further discussions on formu-

ble alternative allocation regimes. An analysis of the formulary apportionment alternative would also expand the scope of this book beyond what could be addressed within the time constraints of the research project.⁷ The book will nevertheless provide some limited comments on certain aspects of the relationship between arm's length transfer pricing and formulary apportionment, as this is deemed to contribute to the analysis of the research questions.⁸

1.2. Key terminology and contextualization

Operating profits are business profits before interest expenses and taxes, i.e. sales revenues minus the cost of goods sold and other operating expenses.⁹ The author's analysis is limited to the allocation of operating profits generated through the sale of products or services based on unique intangibles, e.g. a pharmaceutical preparation manufactured on the basis of a patent and sold under a trademark. In the context of transfer pricing, operating profits are determined and benchmarked at the level of the value chain for a par-

lary apportionment (versus the arm's length principle), *see*, e.g. Langbein (1986); Turro (1994); Lebowitz (1999); Kauder (1993); Hellerstein (1993); Sadiq (2001); Hamaekers (2001), at p. 38; Ackerman et al. (2002); McLure (2002); Vincent (2005), at p. 414 (on global profit splits); Hellerstein (2005a); Hellerstein (2005b); Hardy (2006); Benshalom (2007); Roin (2008); Benshalom (2009); Mayer (2009); Angus et al. (2010); Durst (2010); Morse (2010); Durst (2012a); Kroppen et al. (2011); Fleming et al. (2014); Aviyonah (2015); White (2016), at p. 216; Lebowitz (2008); Luckhaupt et al. (2011), at pp. 100 and 107; Gresik (2011); Wilkie (2011), at p. 152; as well as the more sceptical view expressed in Burke (2011). On global tax reform, *see* Brauner (2003). *See also* recent reflections on the usefulness of the arm's length principle in Biegalski (2010); and, in particular, Schoueri (2015). For a theoretical proposal to address intangible property (IP) profit shifting through cost sharing agreements by way of formulary apportionment pricing, *see* Benshalom (2007), at pp. 648 and 679. *See* Brauner (2008), at p. 160, on the use of a formulary apportionment approach to IP valuation.

7. For an interesting economic analysis of the relationship between the separate entity approach and formulary apportionment, *see* Altshuler et al. (2010), a study that also highlights some of the problems associated with formulary apportionment.

8. *See* the discussion in secs. 11.2. and 26.6.

9. This description will suffice for now. A more in-depth understanding of the concept is primarily necessary for the purpose of analysing the one-sided transfer pricing methods (the gross [resale price and cost plus] and net [comparable profits method (CPM)/transactional net margin method (TNMM)]) and for understanding the historical context in which the TNMM was introduced into the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TPG) in 1995, in particular the OECD arguments against the method. For a further analysis of the concept of operating profits, *see* section 6.2. It should be noted that operating profits do not reflect the costs of debt financing. The issue of intra-group debt financing will not be discussed in this book, as it falls outside the scope of the research questions. An important nuance here is that the profit allocation rules under art. 7 of the OECD

ticular product or service (transactional level), not at the total level for all products and services sold by the relevant group entity (aggregated level). This is fundamentally due to the fact that intangibles are normally used in connection with the creation and sale of specific products or services and contribute to their profits (e.g. the patent for a blockbuster drug or the code for a best-selling software package).¹⁰ A value chain is a set of activities that an enterprise performs in order to deliver a valuable product or service to the market.¹¹ As the author's focus is on profits from products based on intangibles, he will refer to the relevant value chain as an "intangible value chain".

In order to deliver a product to the marketplace, a multinational will perform functions (research and development (R&D), manufacturing, sales, etc.) and apply tangible and intangible assets (plant and property, patents, trademarks, etc.). In doing so, it will incur expenses (for R&D, manufacturing, distribution and marketing, etc.), and thereby also financial risks. All functions performed, assets used and risks assumed along the value chain, from early-phase R&D to the sale of the final product to the end consumer, contribute to the value of the product (and thereby the operating profits derived from its sale) and are, in this sense, value chain contributions (or inputs).

Value chain contributions are conducive to operating profits to varying degrees. Both the US and OECD rules rely on the fundamental distinction

Model Tax Convention on Income and on capital (OECD MTC) allow the allocation of external interest expenses to the permanent establishment (PE) for the purpose of determining its operating profits. This is not a pricing issue, as the interest expenses are at arm's length, but a matter of allowing for external financing of a PE for profit calculation purposes (see the comments in section 17.4.2).

10. For example, in *Eli Lilly v. Commissioner of Internal Revenue* (84 T.C. No. 65 [U.S. Tax Ct., 1985], affirmed in part, reversed in part by 856 F.2d 855 [7th Cir., 1988], the question was how to allocate the operating profits connected to a patent and a trademark employed in the value chain for the drug Darvon and Darvon-N. In both the US *GlaxoSmithKline* settlement (see the analysis in sec. 19.2.5.2.) and the Canadian Supreme Court ruling in *GlaxoSmithKline Inc. v. R.* (2012 SCC 52 [2012], which affirmed 2010 CAF 201, F.C.A., [2010], which reversed 2008 TCC 324 [T.C.C., 2008]; see the analysis of 2012 SCC 52 in sec. 6.7.4.), the question was how to allocate operating profits from sales of the Zantac drug to the connected patents and trademarks. In *Veritas Software Corporation & Subsidiaries v. CIR* (133 T.C. No. 14 [U.S. Tax Ct. 2009], US Internal Revenue Service (IRS) nonacquiescence in AOD-2010-05; see the analysis of the ruling in sec. 14.2.4.), the question was how to allocate profits to the intangibles connected to a software package contributed to a cost sharing agreement (CSA).

11. The general concept was introduced by Porter (1985), but there has been a conscientious focus on the structure of value chains in transfer pricing jurisprudence for far longer.

between unique (or non-routine) and non-unique (or routine) value chain contributions.¹² This distinction is the heart of modern transfer pricing and will be a red thread throughout the different profit allocation contexts discussed in this book. The point of the distinction is that routine value chain inputs only contribute operating profits equal to normal market returns, while non-routine inputs (in practice, unique intangibles) may contribute above-normal returns, which are so-called “super profits”.¹³ Thus, there is a significant profit allocation “cliff effect” associated with the distinction.

Routine contributions typically include contract manufacturing, distribution, marketing and sales functions. Due to their relatively generic nature, a range of enterprises will compete to offer these inputs, driving prices down to a level where there are no super profits, only normal market returns. In contrast, unique intangibles represent market imperfections. Their presence in a value chain may cause the supply-and-demand market mechanism to fail in setting a price that provides mutually beneficial outcomes for the contracting parties. An enterprise that owns unique intangibles may then reap super profits by exploiting them, as competitors will not have access to equivalent input factors. This exclusive market entry barrier position may be shielded by legal protection (patents, trademarks, etc.) or business secrets (e.g. the Coca-Cola recipe), effectively securing the enterprise in a monopoly position to sell certain products or services. This can normally be sustained only for so long due to time-limited legal protection or the emergence of new and superior products or services that render the unique intangibles economically obsolete.

Super profits are known as “residual profits” in the transfer pricing jurisprudence of US law and the OECD MTC.¹⁴ These are the operating profits that are allocated to a group entity that is deemed to own a unique intangible *after* all other group entities that have contributed to the relevant value chain have been compensated with a separately determined normal market return for their routine contributions. In general, residual profits

12. See the US and OECD definitions in para. 6.17 OECD TPG; and US: Treasury Regulations (US Treas. Regs.) § 1.482-6(c)(3)(i)(B), and the analysis of the US and OECD concepts of unique and non-unique value chain contributions in section 3.4.3.

13. Pankiv (2017), at p. 198, touches on this. See also Roberge (2013), at p. 220.

14. Super profits go by different names, depending on the discipline in which the concept is referred to. Economists normally refer to it as an “economic rent”, meaning a profit in excess of the market return to the factors of production (labour and capital). Under perfect competition, this rent will be zero. Financial economists and accountants normally refer to super profits as the rate of return in excess of the capital requirement (risk-adjusted cost of capital), yielding a positive net present value for an investment.

represent a significantly greater amount of operating profits than those allocated as normal market returns.¹⁵ Further, entitlement to residual profits is an ongoing interest in the operating profits generated by the intangible.¹⁶ Thus, a group entity entitled to residual profits will receive such allocation throughout the life of the intangible.

Both the US and OECD rules have traditionally assumed that the operating profits remaining after all routine functions, assets and risks have been remunerated are due *solely* to the unique intangibles exploited in the value chain. The implication of this approach is that all remaining profits are classified as residual profits, and the right to tax this profit is allocated to the jurisdiction where the group entity that is assigned ownership (for transfer pricing purposes) of the unique intangibles is resident (or the source state in the case of a PE).¹⁷ Such an assumption is normally unrealistic. Parts of the remaining profits in an intangible value chain may be incremental profits due to location savings, local market characteristics and synergies. These profits are, in principle, distinguishable from those generated by unique intangibles.¹⁸ The new OECD rules seek to amend the historical flaw that the transfer pricing rules have not sufficiently distinguished operating profits in this manner.¹⁹

The larger the normal market return and incremental operating profits, the smaller the residual profits will be. The question of how the taxing rights to residual profits generated by unique intangibles are allocated among jurisdictions under US law and the OECD MTC will therefore not be possible to analyse without also addressing how normal market returns from the same intangible value chain are allocated among routine value chain contributions and how incremental operating profits due to cost savings, local market characteristics and synergies are allocated among the involved jurisdictions. This is because the residual profits, due to unique intangibles,

15. This line may be blurred in some scenarios. For instance, in the context of intangible development under the OECD TPG, the profits allocable to research and development (R&D) financing may become significant, resembling residual profits (as the author will revert to in sec. 22.4.).

16. This stands in contrast to a separate normal market return to routine value chain contributions. If no such contributions are rendered in a given income period, no compensation will be allocated.

17. See also Francescucci (2004a), at p. 72.

18. See, however, Kane (2014) for an interesting discussion of whether synergy value should be seen as an intangible.

19. See the analysis in ch. 10. See also Francescucci (2004a), at p. 72, for a discussion of the allocation of incremental profits (in the historical context of the 1995 OECD TPG).

are the operating profits that remain after these two groups of profits have been allocated.

It has been claimed that the arm's length principle is "flawed", as it supposedly is unable to account for and allocate parts of the profits that big multinationals generally make, i.e. residual profits from unique intangible property (IP) and incremental profits from economies of scale and integration.²⁰ The rationale is that multinationals are able to create such profits while unrelated parties are not. Thus, if the profits of a multinational are allocated among its group entities, and thus among jurisdictions, based on comparison (benchmarking) with the pricing applied between unrelated parties, the intra-group pricing will always "miss out" on the residual and incremental profits, as such profits do not exist among third parties. The author is sceptical as to whether the bulk of this criticism is indeed justified, taking into account the transfer pricing methodologies currently at offer under the US and OECD arm's length regimes for allocating taxing rights to business profits.²¹

All benefits derived by multinationals due to their assets and organization (unique IP, integrated value chains, synergies, cost savings, etc.) materialize in profits through the sale of products and services to third parties in market jurisdictions where the multinational does business. The US and OECD transfer pricing methods will allocate *all* of these profits to the group entities that have contributed to the value chains through which the profits were created. The critics of the arm's length principle claim – and rightfully so – that this allocation is difficult (if not impossible) to carry out if it is to be based on third-party comparables for the unique value chain contributions (unique IP), as such comparables simply do not exist. On this point, however, it is important to remember (as the critics not always do) that multinationals do not *only* use unique value chain inputs, but they also use a lot of *generic* (or routine) inputs, for which there indeed *are* third-party comparables available. Thus, the key is to recognize that allocation of profits from controlled transactions can then be based on benchmarking such routine value chain inputs, resulting in a normal market return profit allocation to the tested party and treating the remaining profit as a residual that either shall be allocated *fully* to the controlled party that contributes the unique value chain input (under the comparable profits method (CPM)/

20. For an overview of the debate, *see*, in particular, Schön (2010a), at pp. 233-234; and Schoueri (2015), at p. 698. For further discussions, *see*, e.g. Durst (2010); Kobetsky (2008); Lebowitz (2008); and Francescucci (2004a); as well as much of the formulary apportionment discussions referred to in the works mentioned in *supra* n. 6.

21. The transfer pricing methods are analysed in part 2 of the book.

TNMM) or be *split* among the controlled parties if they both contribute such unique inputs (profit split method).²² Both the normal return and residual profits will be effectively allocated among jurisdictions through the application of these transfer pricing methods that operationalize the arm's length principle. None of the multinational's profits will then be "missed". This fact seems to be recognized by at least some now.²³

My impression is that the critics that claim that the arm's length principle is "flawed" may have based their reasoning on an inaccurate understanding (likely influenced by the *historical* dominance of the comparable uncontrolled transaction (CUT) method) of how the *current* transfer pricing methods actually work in practice. For instance, critics often focus solely on the CUT method without recognizing that other transfer pricing (the "profit-based") methods in fact dominate the transfer pricing practices of both tax authorities and taxpayers worldwide nowadays. In order to facilitate a more nuanced debate, critics should, in the author's view, take into account that the arm's length principle does not equal the CUT-method, but encompasses also a range of other – and effective – pricing methodologies.²⁴ In fact, the CUT method will only rarely be applicable at all to allocate profits from the typical IP-dominated value chains of multinationals.²⁵ The key methods in practice are the CPM/TNMM and the profit split method,²⁶ but the workings of these are seldom highlighted by critics. Further, in light of the fact that the 2017 OECD TPG contain elaborate provisions for allocating residual profits from unique IP²⁷ and also address how incremental profits from cost savings, local market characteristics and synergies shall be distributed among jurisdictions,²⁸ there should, in the author's view, be little doubt that the arm's length principle – as it today is operationalized through the methodology set out in the OECD TPG – actually *does* allocate such profits among jurisdictions and thus, in this sense at least, should not be regarded as "flawed".

22. This approach is the core of the profit-based methodology paradigm introduced in the 1988 US White Paper; *see* the analysis in sec. 5.3.3. (with further references).

23. *See* Peng (2016), at p. 383 (*see also* p. 380) with respect to TNMM allocation, and p. 385 for profit-split-method allocation. *See also* Schoueri (2015), at p. 699.

24. The current US and OECD transfer pricing methodologies, as applied to IP value chains, are analysed in part 2 of the book.

25. *See* the analysis of the comparable uncontrolled transaction (CUT) method in ch. 7.

26. *See* the analyses in ch. 8 and ch. 9, respectively.

27. *See* the analysis of the 2017 OECD provisions for allocating residual profits from intra-group developed manufacturing and marketing IP in ch. 22 and ch. 24, respectively.

28. *See* the analysis of the OECD guidance in ch. 10.

There is no doubt that the arm's length principle can be criticized for a whole range of issues (e.g. ambiguous and often imprecise allocation rules, significant compliance costs due to documentation requirements, etc.), but the author does find it very difficult to see that the arm's length principle is unable, as the critics claim, to allocate all of a multinational's profits due to the absence of third-party comparables that reflect residual profits from unique IP and incremental profits from local market characteristics and synergies.

1.3. Research questions and structure

The primary research question is how the taxing rights over operating profits from intangible value chains shall be allocated among jurisdictions under IRC section 482 in US law and Articles 7 and 9 of tax treaties based on the OECD MTC.

Applied in the context of intangible value chains, the US and OECD profit allocation rules will generally be relevant in the exploitation phase of an intangible's life. There will normally be no need to allocate profits before an intangible has been successfully developed and commercialized, as it will generate profits first when it is exploited through the sale of products and services.²⁹ Prior to this phase, there will be no profits to allocate.

The profit allocation assessment begins by splitting the total operating profits from the intangible value chain among the value chain contributions; in other words, among:

- (1) routine value chain contributions (manufacturing, distribution, etc.), which are assigned normal market return profits;³⁰
- (2) location savings, local market characteristics and synergies, which are assigned incremental profits; and
- (3) non-routine value chain contributions (i.e. unique intangibles), which are assigned the residual profits.

29. It may, however, be that an in-development intangible is transferred among group entities. An arm's length charge for the transfer, in the absence of a CUT, will likely need to rely on a valuation in which one of the key parameters will be an estimate of the profits that can be generated through *future exploitation* of the intangible. See the analysis of the OECD guidance on IP valuation in ch. 13.

30. For the purpose of this overview, the author deems a separately determined risk-adjusted rate of return to intangible-development-funding contributions (as discussed in sec. 22.4.) to be included in this category of profits.

This split is governed by the US and OECD transfer pricing methodologies,³¹ the analysis of which may be broken down into a range of different sub-questions, depending on the context and specific methodology used. The purpose of the methodologies is twofold.

First, they aim to split the total operating profits among the above three categories of value chain contributions. This is a question both of causality and value, i.e. the value chain inputs that have contributed to the total profits must be identified and the degree of profit contribution from each input must be determined (the amount of profits allocable to the input).

Second, the methodologies aim to assign the categorized profits to the group entities (or headquarters or PE) that have contributed the relevant value chain inputs. The assignment will normally be straightforward for routine value chain contributions. For example, it will be causally clear which group entity has performed contract manufacturing or marketing functions. It may, however, be more complex to assign incremental operating profits due to cost savings, local market characteristics and synergies to a specific group entity, as the determination does not depend on causality, but rather on how third parties would have allocated the profits. For unique intangibles, the transfer pricing methodologies only determine the *amount* of residual profits to be allocated to a specific unique intangible. They *do not provide a link* between the determined residual profit amount and the group entity to which the amount is to be allocated. That task is left for the US and OECD intangible ownership provisions to deal with. These latter provisions connect the residual profits to specific group entities within the multinational.

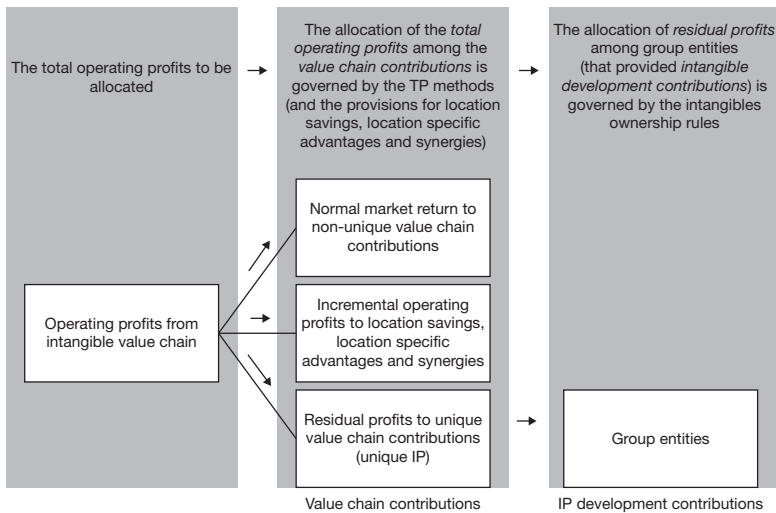
The basic principle underlying both the US and OECD intangible ownership provisions is that the residual profits generated in the exploitation phase shall be allocated among the group entities that participated in the creation of the intangible. This profit allocation shall be carried out in proportion to the relative values of the involved group entities' routine and non-routine contributions in the development phase of the intangible's life. Through this profit assignment to a specific group entity (or headquarters or PE), the residence (or source) jurisdiction of the relevant entity is allocated the right to tax the residual profits. In this way, taxing jurisdiction

31. For the purpose of this overview, the author uses the term "transfer pricing methodologies" broadly to not only encompass the pricing methods, but also the OECD profit allocation guidance on incremental profits from location savings, market characteristics and synergies.

over operating profits from intangible value chains is divided among the jurisdictions through which the multinational routes its value chains.³²

The primary research question must therefore be answered through an analysis of the US and OECD transfer pricing and intangible ownership provisions relevant to intangible value chains, as these provisions in concert determine the profit allocation. The author seeks to illustrate this profit allocation process in figure 1.1.

Figure 1.1



Thus, the transfer pricing provisions determine the *amount* of profits that shall be assigned to an intangible, and the ownership provisions determine *which group entity*, and therefore which jurisdiction, the amount shall be assigned to.

While the transfer pricing rules are mainly relevant in the exploitation phase of an intangible's life, they are, however, also of relevance in the development phase. Group entities that contribute routine development inputs (e.g. laboratory equipment and research facilities) to the creation of an intangible but are not assigned entitlement to subsequent residual profits un-

32. See Schön (2010a), at p. 230, on the two-sided function of the arm's length principle with respect to the allocation of taxing rights (income allocation first to persons and then jurisdictions). See also Schön (2010b) on the topic of the allocation of taxing rights.

der the intangible ownership provisions are assigned a concurrent normal market return in the development phase for their contributions through the transfer pricing methods. Comparatively, the intangible ownership provisions (for the purpose of allocating residual profits in the exploitation phase of an intangible's life) look towards which functions, assets and risks were contributed to the creation of the IP by the involved group entities in the development phase and allocate profit in a way much akin to the profit split methodology. Thus, there is an interplay between the transfer pricing and intangible ownership provisions in both the intangible development and exploitation phases.

Nevertheless, as the focus of the US and OECD transfer pricing and intangible ownership provisions is on the remuneration of value chain contributions in the exploitation phase and intangible development contributions in the development phase, it is necessary to analyse the provisions separately, which the author does in parts 3 and 4 of this book, respectively.³³ This basic structure of the book mirrors that of a practical transfer pricing analysis. The structure, however, departs from the chronology of section 482 of the US Treasury Regulations and the OECD TPG, where the intangible ownership issue is addressed before the transfer pricing issues. The author finds that the structure of this book is more appropriate for analytical purposes. It reflects the fact that the material content of the ownership rules has converged significantly with the transfer pricing methodologies³⁴ and is best seen as a specific application of these. Thus, the structure of this book offers the benefit of seeing these applications in light of more general principles. It is also the author's view that this makes the book easier to read, as it otherwise would have been necessary to refer to the transfer pricing analysis when analysing the intangible ownership provisions.³⁵

33. The author refers to the introductions to parts 3 and 4 of this book for detailed outlines of the analysis in each respective part.

34. In particular, the profit split method, which is analysed in ch. 9.

35. As mentioned, group entities that contribute to the development of an intangible and are not compensated with residual profits shall be allocated a concurrent normal market return compensation for their efforts. In other words, such compensation will not be drawn from the operating profits generated through the exploitation of the intangible once fully developed. Thus, the compensation of such entities will, in principle, be triggered *before* the profit allocation issues discussed above in this section. This does not, however, apply for the remuneration of intangible development financing under the OECD TPG, which is linked to the profits generated through the exploitation of the developed intangible. This entails that, in practice, it will only be the remuneration of group entities that have rendered routine development contributions that shall be allocated compensation concurrently throughout the R&D phase. While it could be argued that it would be beneficial to discuss the remuneration of these entities before the main

The secondary research question, which is dependent on the results of the analysis of the primary research question, is to provide a critical assessment of whether the current US and OECD profit allocation solutions are useful or if they ideally should be altered, and if so, to propose relevant amendments. This is addressed throughout the book concurrently and in connection with the analysis of each sub-question under the primary research question.

The author will introduce fundamental concepts in part 2 of the book. The topics discussed there are closely interwoven with the subsequent analysis of the profit allocation rules and form the platform for, and should be seen as an integrated part of, the analysis of the research questions. The author will outline the business and tax reasons for intangible value chains, with a focus on the concept of foreign direct investments and how they relate to super profits.³⁶ He will also introduce the centralized principal model, which is commonly applied by multinationals for profit allocation purposes. A discussion of the 2015 OECD nexus approach for preferential taxation of super profits under IP regimes is also provided. Further, the author will discuss the types of controlled intangible transactions that are encompassed by the US and OECD profit allocation rules, as well as the US and OECD intangibles definitions.³⁷

1.4. Methodology

This book is a legal analysis carried out under the academic traditions of the discipline of law. The main object of legal research is *text*. The main research activity is *interpretation*. Hermeneutics is, broadly stated, the philosophy and methodology of text interpretation.³⁸ Thus, legal research can be seen as a hermeneutical discipline.³⁹ Its closest academic parallels are likely theology and the study of literature. Legal research may also be seen as a normative discipline.⁴⁰ The researcher will not always be able to find a legal norm that exists independently of his own interpretative contribu-

allocation issues discussed above in this section, the author finds it to be a small sacrifice to delay the discussion of this issue in order to attain, in his view, an undoubtedly better overall structure of the book.

36. See ch. 2.

37. See ch. 3.

38. For a somewhat diverging definition, cf. Bernt & Doublet (1998), at p. 181.

39. For a fascinating hermeneutical perspective on legal research, see Bernt & Doublet (1998), at p. 178. See also Hoecke (2011), ch. 1, p. 4.

40. See Hoecke (2011), p. 10.

Notes

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