Intangible-Related Profit Allocation within MNEs based on Key DEMPE Functions: Selected Issues and Interaction with Pillar One and Pillar Two of the Digital Debate

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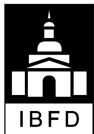

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Intangible-Related Profit Allocation within MNEs based on Key DEMPE Functions: Selected Issues and Interaction with Pillar One and Pillar Two of the Digital Debate

Vikram Chand* and Giovanni Lembo**

The main objective of the present contribution is to provide the authors' perspective on selected issues vis-à-vis the DEMPE approach. After an introduction to the DEMPE concept, the contribution analyses a *scope-related question*, that is, whether article 9 permits or restricts DEMPE-related structural adjustments on the basis of either actual conduct or the commercially irrational exception. To a certain extent, the application of these matters vis-à-vis profit allocation for intangible-related transactions under article 7 is also analysed. Thereafter, it analyses a *conceptual issue* pertaining to the role of the funder. In particular, it analyses whether the residual profits derived from intangible exploitation should be allocated only to the entity that performs key DEMPE functions, or whether part of such a residual should be allocated to the funder of the intangible, in the event that the latter is an entity different from the entity performing the DEMPE activities. *On the practical side*, the article initially discusses the challenges that arise for both taxpayers and tax administrations in implementing the DEMPE approach and thereafter proposes certain ways to mitigate those challenges. *Finally*, the article discusses the role of the DEMPE concept in the ongoing debate on the digitalization of the economy. In particular, it discusses the role of the DEMPE concept in a profit shifting, tax competition and Pillar Two context. Moreover, it examines the role of the DEMPE concept in determining the paying entity/surrender jurisdiction in the Pillar One discussion vis-à-vis Amount A. The article concludes with some key suggestions for taxpayers and policy makers. The contribution is based on recent case law from across the globe, the latest guidance issued by tax administrations and policymakers, the OECD blueprints for Pillar One and Pillar Two and the scholarly literature.

1. Introduction

The importance of intangible assets within the global economy is increasing significantly. This is because the value of many multinational enterprises (MNEs) is increasingly attributable to the ownership and exploitation of valuable intangibles such as patents, trademarks and brands.[1]

Transfer pricing (TP) of intangibles or intellectual property (IP) has always been a major challenge for MNEs and tax administrations, and it is expected to become even more challenging in the light of the guidance issued by the Organisation for Economic Co-operation and Development (OECD) in the 2017 revisions to chapter VI of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).[2] In particular, some chapters of the OECD Guidelines (2017) have been amended pursuant to the base erosion and profit shifting (BEPS) project Actions 8-10 Final Reports, published on 5 October 2015.[3] The purpose of BEPS Actions 8-10 was to align TP outcomes with value creation, in particular in an intangible context, by resorting to a key DEMPE functions approach (where DEMPE stands for development, enhancement, maintenance, protection and exploitation) and tackling the use of "cash box" entities (i.e. entities with very limited or no functionality).

The main purpose of the article is to critically assess the key DEMPE functions approach, mostly in relation to structures that deal with exploitation of trade-related intangibles. In order to do so, it firstly discusses the impact of the updated TP guidance on a trade intangibles exploitation structure (section 2.). It then discusses issues with respect to the key DEMPE functions approach: in particular, selected scope, conceptual and practical issues. Regarding scope-related issues, the article analyses the question of whether article 9 of the OECD Model Tax Convention on Income and on Capital (OECD Model)[4] permits key DEMPE

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1. O. Hoor, *Transfer Pricing in Luxembourg* 159 (Legitech 2018).
2. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), Primary Sources IBFD [hereinafter *OECD Guidelines*].
3. OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Report* (OECD 2015), Primary Sources IBFD [hereinafter *Actions 8-10 Final Reports*].
4. *OECD Model Tax Convention on Income and on Capital* art. 9 (21 Nov. 2017), Treaties & Models IBFD. For academic commentary on this article, *see* E. Baistrocchi, *Article 9:*

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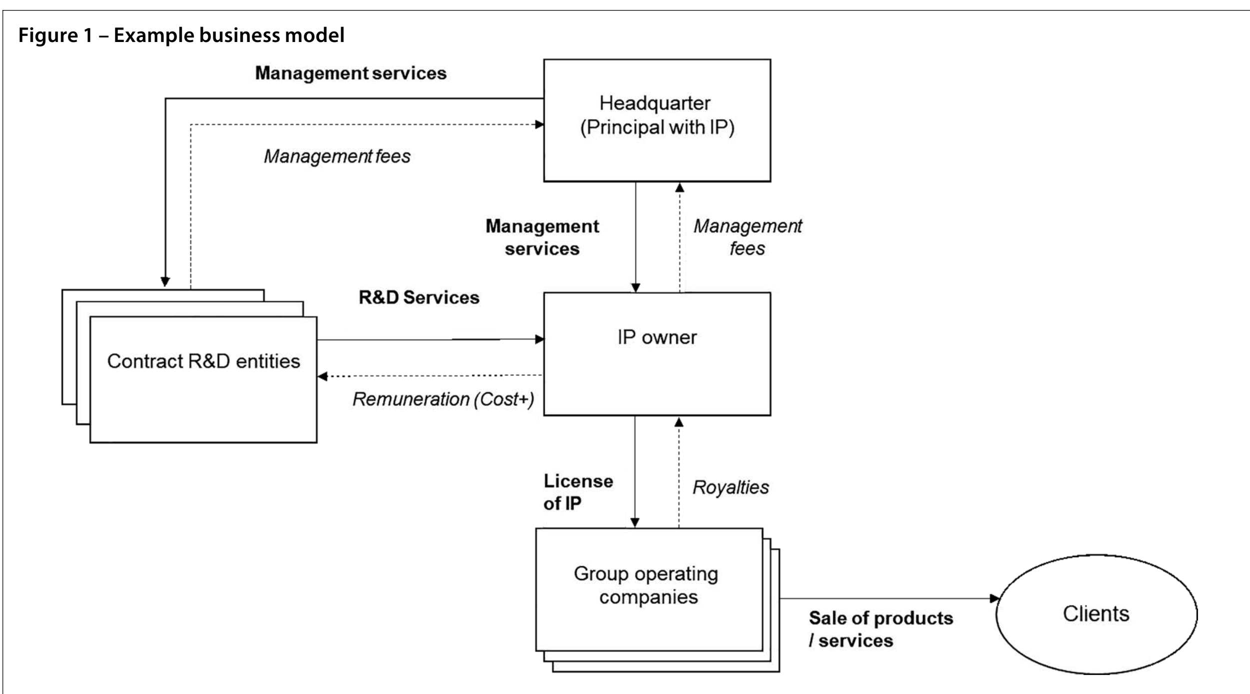
Figure 1 – Example business model



functions-related structural adjustments (section 3.).[5] On the conceptual side, it discusses whether residual profits from intangible exploitation should be allocated to an entity that performs key DEMPE functions only, or can a part of residual profit be allocated to a funder that is separate from the entity performing the DEMPE activities? (section 4.). On the practical side, the article initially discusses the challenges that arise for both taxpayers and tax administrations in implementing the key DEMPE functions approach and thereafter discusses certain ways to mitigate those challenges (section 5.). As a limitation, sections 1.-5. will not engage in a detailed discussion on the impact of the key DEMPE functions approach on distribution structures that deal with exploitation of marketing-related intangibles (such as trademarks or trade names). Finally, the article examines the role of the key DEMPE functions concept in the ongoing debate on the digitalization of the economy (section 6.). In particular, it discusses the role of the key DEMPE functions concept in a profit shifting, tax competition and Pillar Two context. It then analyses the role of the key DEMPE functions concept in determining the surrender entity/surrender jurisdiction in the Pillar Two discussion vis-à-vis Amount A. The article concludes with some key observations for taxpayers and tax administrations, and, in particular, for policy officials (section 7.).

2. The Impact of Key DEMPE Functions: An Illustration vis-à-vis Trade Intangibles

IP structures may take different forms: for instance, they may entail the use of a principal owning the IP or the setting-up of a separate IP company, and/or they may be based on cost contribution arrangements (CCAs) between the parent company performing research and development (R&D) activities and the IP company.[6] A frequently observed business model from the past is depicted in Figure 1. [7]

To elaborate, under this model, the Headquarters (Head Co) would set up a separate IP Company (IP Co) with large amounts of capital and with limited or no staff. If there were limited staff, such personnel were primarily responsible for carrying out administrative activities associated with the IP. Then, the IP Co would delegate the development of intangibles to contract R&D entities (R&D Co) pursuant to a legally executed research contract. The R&D companies received a cost-plus remuneration for their activities. The results of the research were legally owned by the IP Co, even though, in reality, the R&D Co was making all the key decisions associated with the IP development, such as control over R&D strategy, R&D design, R&D budgets and so on. Thereafter, the IP Co licensed such IP to the group operating companies and received royalty

Associated Enterprises – Global Tax Treaty Commentaries, Global Topics IBFD (accessed 5 Nov. 2020).

5. J. Wittendorff, *BEPS Actions 8-10: Birth of a New Arm's-Length Principle*, 81 Tax Notes Intl. 84, 322 (2016).

6. M. Screpante, *Rethinking the Arm's Length Principle and Its Impact on the IP Licence Model after OECD/G20 BEPS Actions 8-10: Nothing Changed but the Change?*, 11 World Tax J. 3, sec. 2. (2019), Journal Articles & Papers IBFD.

7. Example of business model inspired by the presentation by Isabel Verlinden (PwC) on *Transfer Pricing and Intangibles*, during the 2017 edition of the Executive Program in Transfer Pricing, UNIL.

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income. In many situations, the Head Co also provided management services to IP Co and R&D Co.

In the pre-BEPS era, several arguments were made that the development/financial risk associated with the intangible development should be allocated to the IP Co, as the latter company bore those risks pursuant to contractual arrangements. As a result, IP Co was legally entitled to ownership of the (potential) intangible resulting from the research and the related profit derived from the intangible.[8] It was also argued that such an outcome was, in principle, consistent with the conditions that independent parties would have agreed on in similar circumstances observable in a capitalist market economy.[9] In other words, a company being part of an MNE that invested capital and bore risks in relation to the investment had to become the residual claimant of the business results, as would occur if such an investment had been made by an independent company, irrespective of the relevant functions performed in relation to the management of the investment/asset.[10]

On the other hand, the OECD Guidelines (2017)[11] provide that a company within a MNE will be entitled to derive returns in relation to the intangibles to the extent it performs *key DEMPE functions*, that is, performing and controlling DEMPE activities, controlling DEMPE-related risks and having financial capacity to assume the relevant risks pertaining to the intangible. The updated guidance aims at allocating the profit (or losses), as well as the costs and other burdens relating to the intangibles, to each entity belonging to MNEs according to the actual contribution to the performance of value-creation functions specifically relevant for intangibles. A six-step framework, similar to the framework developed in the context of control over risk and financial capacity to bear risks in chapter I, is now provided.

– Step 1 pertains to the identification with specificity of the intangibles used or transferred in the transaction and the economically significant risks associated with the DEMPE activities pertaining to the intangibles. According to the OECD Guidelines (2017), neither the accounting nor the legal definition is decisive in the recognition of intangibles for TP purposes.[12]

– Step 2 requires the identification of all the relevant contractual arrangements. In principle, the legal owner will be considered the owner also for TP purposes. In cases in which it is not possible to identify a legal owner based on the contracts and available documentation, the legal owner will be the member of the MNE group that takes decisions concerning the exploitation of the intangible and has the practical capacity to restrict other members from using the intangible.[13]

– Step 3 requires carrying out a deep functional analysis, identifying the parties performing functions, using assets, and managing risks involving the DEMPE activities. Essentially, this step requires the preparation of a functional analysis, focused in particular on which parties control specific economically significant risks and which parties control any outsourced functions.[14] Consequently, the functional analysis should focus on identifying which members: (i) perform and exercise control over DEMPE functions;[15] (ii) provide funding and other assets;[16] and (iii) assume the various risks associated with the intangible(s).[17] When identifying the economically significant risks with specificity, the OECD Guidelines (2017) note that it is important to distinguish between risks linked to providing funding for the investments (for example, financial risk) and the operational risks linked to the operational activities for which that funding is used (for example, development risk).[18]

– Step 4 requires assessing the consistency between the terms of the relevant contractual arrangements and the actual conduct of the parties. This step consists of assessing whether the party assuming economically significant risks actually controls the risks and has the financial capacity to assume the risks in connection with the DEMPE activities related to the intangibles.

– Step 5 requires an accurate delineation of the transaction that is to be priced. This step consists of delineating the actual controlled transactions involving the key DEMPE functions in light of the legal ownership of the intangibles, the other relevant contractual relationships under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets, and risks, taking account of the detailed guidance on the allocation of risks. According to this guidance, when an associated enterprise of an MNE group assuming a certain

8. Hoor, *supra* n. 1, at 167; A. Musselli & A. Musselli, *Rise of a New Standard: Profit Location in Countries of Important Intangible Functions Managers*, 24 Intl. Transfer Pricing J. 5, sec. 1. (2017), Journal Articles & Papers IBFD.
9. Id., at sec. 1.
10. Id.
11. *OECD Guidelines* (2017), *supra* n. 2, at ch. VI; OECD/G20, *Actions 8-10 Final Reports*, *supra* n. 3, at 63-140.
12. M. Pankiv, *Post-BEPS Application of the Arm's Length Principle to Intangibles Structures*, 23 Intl. Transfer Pricing J. 6, sec. 2.1. (2016), Journal Articles & Papers IBFD.
13. *OECD Guidelines* (2017), *supra* n. 2, at para. 6.40.
14. Id., at para. 6.48.
15. Id., at paras. 6.50-6.58.
16. Id., at paras. 6.59-6.64.
17. Id., at paras. 6.65-6.68.
18. Hoor, *supra* n. 1, at 162; *OECD Guidelines* (2017), *supra* n. 2, at para. 6.65.

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risk contractually does not have the actual control and the financial capacity to assume that risk, then the risks should be allocated to the enterprise actually exercising control and having the financial capacity to assume the risk.[19] The key concept provided by the updated guidance is that legal ownership of intangible, by itself, does not confer any right to ultimately retain the returns derived from the exploitation of the intangible. In the event that the legal owner neither exercises control over the DEMPE function nor has the financial capacity to bear the DEMPE-related risks, it would not be entitled to any portion of the returns derived from the intangibles.[20] Therefore, legal ownership and contractual relationships serve simply as reference points for identification of controlled transactions relating to intangibles.[21]

– Step 6 deals with arm's length pricing. When possible, the arm's length prices determined for these transactions should reflect each party's contributions, including functions performed, assets used and risks assumed.

Pursuant to the aforementioned six-step framework, if legal ownership or ownership by agreement is inconsistent with the underlying economic reality represented by the DEMPE concept, the remuneration of the IP Co would depend on how significant its involvement in the DEMPE functions is.[22] If the IP Co does not perform any key DEMPE functions and does not bear any risk in relation to those functions (e.g. if it is a low-functional administrative entity), it will not be entitled to receive any major returns (or incur any loss) arising from the exploitation of intangibles or it would need to compensate the other member(s) of the MNE group according to their involvement in the DEMPE functions and related risks (for instance, the R&D Co). The IP entity in such circumstances would be entitled to a low or no cost-plus return. Moreover, under the OECD Guidelines (2017), when one member of an MNE group funds the development activity (IP Co) while another member of the group performs all the key DEMPE functions[23] (R&D Co), the entity providing the funds should generally expect a risk-free return[24] only if that entity does not exercise control over the financial risks associated with the funding. Consequently, the updated guidance seems to discourage centralized intangible ownership models based on an IP company or principal entity owning the IP only "on paper".[25]

That said, if the IP Co controls the financial risks associated with the funding, then that entity is entitled to a risk-adjusted return on its funding. The risk-adjusted return should be based on the cost of capital or the return of a realistic alternative investment with comparable economic characteristics.[26] Furthermore, to the extent that the IP Co legally owning the intangibles assets performs all or a significant portion of the key DEMPE functions, it will still be entitled to all (or a large share) of the income derived from the intangibles. Thus, the new framework incentivizes an MNE using a centralized ownership structure not only to have that central entity providing financing, but also to transfer economic activity and DEMPE functions to the entity.[27]

An important takeaway from the updated guidance is that the labels applied to transactions should not affect the TP analysis; instead, the facts and circumstances of each individual case must be examined.[28] Therefore, the six-step approach described previously is transactional and not based on an analysis of the overall functionalities of any given legal entities within the MNE group.[29] This means that functions and risks are delineated based on a given transaction falling into one of the above-mentioned categories of transactions involving intangibles. Therefore, the allocation of returns within an MNE requires the application of the six-step process in order to determine which entity is entitled to risk-related returns on a transaction-by-transaction basis. The rationale given by the OECD is that an entity may have the capacity to bear or perform a function in a transaction with an affiliate, but not necessarily in the same way as with another affiliate.[30]

The entitlement of any member of the MNE group to profit or loss relating to differences between actual (ex-post) and a proper estimation of anticipated (ex-ante) profitability will depend on which entity or entities in the MNE group, in fact, assume the risks as identified when delineating the actual transaction.[31] Therefore, the delineation of the actual transaction plays a key role in the allocation of the risks and the returns in relation to the intangible under the OECD Guidelines (2017). Provided that the contractual arrangements reflect the facts and circumstances of the real transaction undertaken, they will serve as basis for the functional analysis and for the delineation of the actual transaction; otherwise the actual conduct of the parties will prevail.[32]

19. *OECD Guidelines* (2017), *supra* n. 2, at para. 1.98 and paras. 6.71-6.72.
20. Id., at para. 6.42.
21. Id., at para. 6.43.
22. Pankiv, *supra* n. 12, at sec. 3.2.
23. *OECD Guidelines* (2017), *supra* n. 2, at para. 6.61; OECD/G20, *Actions 8-10 Final Reports*, *supra* n. 3, at 81.
24. OECD/G20, *Actions 8-10 Final Report*, *supra* n. 3, at 65.
25. Hoor, *supra* n. 1, at 167.
26. *OECD Guidelines* (2017), *supra* n. 2, at para. 6.62; OECD/G20, *Actions 8-10 Final Reports*, *supra* n. 3, at 81.
27. Id.
28. *OECD Guidelines* (2017), *supra* n. 2, at para. 6.89.
29. Screpante, *supra* n. 6, at sec. 3.3.1.
30. Id.
31. Pankiv, *supra* n. 12, at sec. 2.2.3.
32. Screpante, *supra* n. 6, at sec. 3.3.1..

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Once the transaction is accurately delineated it needs to be priced. According to the OECD Guidelines (2017), the best methods to be used in transactions involving transfers of intangibles or rights in intangibles will usually be the comparable uncontrolled price (CUP) method, the profit split method or income-based methods.[33] In particular, with regard to income-based methods, the OECD Guidelines (2017) endorse the application of valuation techniques based on the discounted value of projected income streams expected to be derived from the exploitation of the intangible.[34] Against this backdrop, selected issues vis-à-vis the key DEMPE functions concept are now analysed.

3. Scope-Related Issue

3.1. The issue

Collier and Andrus (2017) state that article 9 of the OECD Model entails uncertainties which makes a proper understanding of its technical scope difficult.[35] The authors further state that the OECD Guidelines (2017) have shifted the focus from contractual arrangements to the actual conduct of the parties. Essentially, when the actual conduct differs from the contracts (e.g. when the capability to control contractually assumed risks is not present), the terms of the transaction may be adjusted accordingly.[36] However, the increased ability to restructure transactions may cause uncertainties and will make TP disputes more likely. As seen in Step 5 of the framework applied for the purpose of allocating the profits derived from intangibles (section 2.), the key DEMPE functions concept authorizes the tax administration to look beyond legal arrangements and re-allocate the income/profits from the IP Co to the R&D Co, based on the underlying economic reality of the transaction (or economic substance). The question analysed in this section is whether article 9 of the OECD Model restricts such key DEMPE functions-related reallocations or other structural adjustments in any manner (e.g. in the case of commercially irrational structures).

At the outset, a preliminary question arises as to the legal status of the OECD Guidelines (or the UN Practical Manual on Transfer Pricing for Developing Countries (UN 2017) (UN Manual))[37] vis-à-vis the interpretation of article 9. This question is important for the purpose of this contribution, as several references will be made to the updated OECD Guidelines. Naturally, the answer to the question is linked to the legal status attributed to the Commentary on the OECD Model, as the Commentary recommends referring to the OECD Guidelines. The issue has been discussed extensively in literature and it is not the purpose of this contribution to go through all the positions again.[38]

In the present authors' view, the attempt to classify the Commentary on the OECD Model under one provision or another of the Vienna Convention on the Law of Treaties (1969) (VCLT) is not a profitable exercise. This is because the interpretation of provisions contained in the VCLT are not exhaustive. The draft Commentary to the VCLT makes this clear, and states that the drafters, in drafting the interpretation rules of the VCLT, never intended articles 31 and 32 of the VCLT to be a complete codification of all principles and maxims to be adopted in interpreting treaties.[39] Therefore, even if the Commentary on the OECD Model cannot be fitted into articles 31 and 32 of the VCLT, it is submitted that it should be considered relevant in the tax treaty interpretation process. Therefore, the position adopted in this contribution is that the Commentary on the OECD Model, as it exists at the time of conclusion of a tax treaty, is not a legally binding instrument but nevertheless plays an important role in the tax treaty interpretation process.[40]

It follows that the OECD Guidelines are generally of a non-binding character.[41] Some commentators, such as Bullen (2011), support this proposition and argue that the OECD Guidelines are soft law.[42] This indicates that the Commentary and Guidelines can be considered equivalent to soft law or as having somewhat greater power than mere soft law. In this regard, a passage may be quoted from the Supreme Court of Canada's decision in *GlaxoSmithKline* (2012),[43] in which it held that "[t]he Guidelines contain commentary and methodology pertaining to the issue of transfer pricing. *However, the Guidelines are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to s. 69(2) rather than any particular methodology or commentary set out in the Guidelines*." [Emphasis added.][44]Judge Patrick Boyle and Justice Owen also

33. *OECD Guidelines* (2017), *supra* n. 2, at para. 6.153; OECD/G20, *Actions 8-10 Final Reports*, *supra* n. 3, at 102.
34. Id.
35. R. Collier & J. Andrus, *Transfer Pricing and the Arm's Length Principle* para. 4.81 (Oxford University Press 2017).
36. Id., at para. 7.43.
37. *UN Practical Manual on Transfer Pricing for Developing Countries* (UN 2017) [hereinafter *UN Manual* (2017)].
38. For a recent discussion of the *OECD Guidelines*, *see* M. Kobetsky, *The Status of the OECD Transfer Pricing Guidelines in the Post-BEPS Dynamic*, 3 Intl. Tax Stud. 2 (2020), Journal Articles & Papers IBFD.
39. *Draft Articles on the Law of Treaties with commentaries 1966* sec. 3, introduction, paras. 4-5, in UN, *Yearbook of the International Law Commission 1966* 218-219 (vol. II, UN 1966).
40. For a detailed analysis, *see* V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties (with special references to the BEPS project)* 108-116 (Schulthess 2018).
41. Collier & Andrus, *supra* n. 35, at para. 8.84.
42. A. Bullen, *Arm's Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing* 38-39 (IBFD 2010).
43. CA: SCC, 18 Oct. 2012, *GlaxoSmithKline Inc. v. Her Majesty the Queen*, [2012] SCC 52, Case Law IBFD.
44. Id., at para. 20.

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supported a similar view in *McKesson* (2013)[45] and *Cameco* (2018)[46] respectively.

Having established that the OECD Guidelines play an important role in the interpretation of article 9, even though they are not legally binding, the issue arises as to which version of the OECD Guidelines should be used to interpret a tax treaty – i.e. is it the OECD Guidelines that existed at the time a treaty was concluded (static approach), or are subsequent commentaries and guidelines also relevant (ambulatory/dynamic approach)? In the present authors' view, a dynamic approach should be used. That said, subsequent versions can be considered if, and only if, they are in the nature of a clarification. Consequently, if the updated or revised guidelines represent a fundamental change, or if the guidelines reverse or contradict previous versions, then those guidelines should be disregarded and should not be considered for the tax treaty interpretation process, especially, with respect to interpreting article 9.[47] It is now possible to turn to the issue of structural adjustments.

3.2. *International guidance on structural adjustments with a focus on intangible ownership*

Article 9(1) of the OECD Model states that "*[w]hen conditions are made or imposed between two associated enterprises in their commercial or financial relations* which *differ from those which would be made between independent enterprises*, then any profits which would, *but for those conditions*, have accrued to one of the enterprises, but, by reason of *those conditions*, have not so accrued, may be included in the profits of that enterprise and taxed accordingly" [emphasis added]. It is widely accepted that price adjustments (such as determining the royalty rate or interest percentages) are authorized by article 9. However, questions have been raised regarding whether article 9 authorizes structural adjustments.

A reference to the question of whether article 9(1) authorizes structural adjustments can be found in the work of the OECD's Working Party No. 6 on the determination of transfer prices (WP6 TP Draft (1978)).[48] Paragraph 15 states:

> In general the approach which is adopted in this report to the adjustment of transfer prices for tax purposes is to *recognise the actual transactions and payments as the starting point for the tax assessment and not, in other than exceptional cases, to disregard them, or substitute other transactions or payments for them* ... The report does, however, recognise that it may be important in considering what is ostensibly interest on a loan to decide whether it is an interest payment or, in reality, a dividend or other distribution of profit. [Emphasis added.] [Hereinafter "the loan example"]

Paragraph 15A goes on to state:

> Contracts and arrangements between affiliated enterprises may often moreover be quite easily altered, expanded or limited by supplementary contracts etc[.] or suspended, extended or even terminated before time. All these alterations may moreover be made retroactively notwithstanding contrary clauses in the contracts or may be put into operation in practice without any formal legal instruments ... Domestic law for example may require goods to be sold outright to a particular national affiliate in a situation where, for cost reasons, the group as a whole would find it more economical to remunerate the relevant enterprise as an agent on a commission basis and thus, in practice, reduces the activities and risks of the affiliate and similarly increases the prices charged to it accordingly, *in short carrying on that particular business in a way which is not comparable with the way in which it would be carried on between independent parties. In such a situation the tax authority may well need to probe below the surface to ascertain the functions of the relevant entities and the respective risks borne by them and on that basis to establish the reality of the transactions in order to assess the arm's length prices relevant to them. In doing so it will need to take all the relevant circumstances into account*. This does not, however, mean that for a valid legal transaction another one more favourable to the tax authorities should be substituted or that the tax authority's commercial judgement should be substituted for that of the management ... *But it does imply that in looking for the arm's length price in such circumstances the tax authorities may be justified in comparing prices charged in uncontrolled transactions which are comparable in reality though not in form with the controlled transaction and possible therefore in looking to transactions of a different legal structure. How far they will be able to do this may depend on whether their tax system puts more emphasis on the substance of transactions than on their legal form in general or in cases where evasion or avoidance of tax is involved.* [Emphasis added.]

The above discussion indicates that the tax administration could look into the actual conduct of the associated parties (in light of their functions and risks) and, based on that conduct, determine the appropriate transfer prices. By doing so, they could look beyond the legal/contractual form.

The above guidance was incorporated in OECD's 1979 report on The Determination of Transfer Prices between Associated Enterprises (1979) (OECD TP Report (1979)).[49] The report states in paragraph 15 that, "as a general principle, tax authorities should

45. CA: TCC, 13 Dec. 2013, *McKesson Canada Corporation v. Canada Revenue Agency*, para. 120, [2013] 404 (TCC), Case Law IBFD.
46. CA: TCC, 26 Sept. 2018, *Cameco Corporation v. Her Majesty the Queen*, [2018] TCC 195, para. 745, Case Law IBFD.
47. For a detailed analysis, *see* Chand, *supra* n. 40, at 112-115; Bullen, *supra* n. 42, at 53-56.
48. OECD Comm. on Fiscal Affairs, Special Working Group on Transfer Pricing of Working Party No. 6, *Transfer Pricing: Draft Consolidated Note*, DAF/CFA/78.13 (5 Sept. 1978), available at https://www.taxtreatieshistory.org/data/pdf/DAF-CFA(78)13E.pdf (accessed 9 Oct. 2020).
49. OECD Comm. on Fisc. Affairs, *The Determination of Transfer Prices between Associated Enterprises* (OECD 1979), available at https://www.taxtreatieshistory.org/data/pdf/CFA(79)1E.pdf (accessed 15 Oct. 2020).

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base their search for an arm's length price on actual transactions and should not substitute hypothetical transactions for them, thus seeming to substitute their own commercial judgement for that of the enterprise at the time when the transactions were concluded (*though there may be some circumstances where the form of transaction has effectively to be ignored* – see paragraphs 23 and 24)" [Emphasis added]. Paragraph 23 goes on to state that, "[i]n general, the approach which is adopted in this report to the adjustment of transfer prices for tax purposes *is to recognise the actual transactions as the starting point for the tax assessment and not, in other than exceptional cases, to disregard them or substitute other transactions for them*" [emphasis added]. The loan example is replicated in this paragraph. Paragraph 24 then goes on to provide that:

> [a]ssociated enterprises are, however, able to make a much greater variety of contracts and arrangements than can unrelated enterprises because the normal conflict of interest which would exist between independent parties is often absent… Moreover, contracts within an MNE could be quite easily altered, suspended, extended or terminated according to the overall strategies of the MNE as a whole and such alterations may even be made retroactively. *In such instances tax authorities would have to determine what is the underlying reality behind an arrangement in considering what the appropriate arm's length price would be.* [Emphasis added.]

The concept of underlying reality was also reflected in the discussion on the intangibles, services and cost contribution agreements. The OECD TP Report (1979), in paragraph 89, provides that:

> [a] prerequisite for allowing payments under licensing agreements as a deduction for tax purposes is that a real benefit should have accrued or be reasonably expected at the time of conclusion of the contract to accrue to the licensee … *It is clearly important to determine what is the underlying reality behind an arrangement irrespective of the latter's formal aspect.*" [Emphasis added.]

In paragraph 170 it is stated that:

> A taxpayer has to produce satisfactory evidence to prove that a service has been performed, a cost incurred and a real benefit, whether actual or potential, received. *To determine what is the underlying reality behind an intra-group service agreement or cost allocation arrangement* is often therefore the crucial question for tax authorities when deciding whether or not to admit the deduction of a payment. [Emphasis added.]

Specifically, in the context of cost contribution agreements, in paragraph 113 the report states that:

> In addition, the participants to the cost contribution arrangement would be expected to be able to demonstrate that the R & D they are paying for is in conformity with the written agreement and has been or will be carried out in practice. All the evidence needed to prove that the research has been performed in the interest and for the expected real benefit of a particular entity would have to be produced at the request of the tax authorities concerned. Here again, it will be more important to look at the *substance rather than the form of an arrangement.* [Emphasis added.]

The discussion once again indicates that the transaction as structured by the taxpayer can be put aside if it does not match with its underlying reality.

In the 1986 OECD Base Companies report (published on 27 October 1986),[50] the OECD highlighted that article 9, when applied from the perspective of the state of residence of the shareholder of a base company, could be used to ensure that the base company is allocated low or no returns if that entity performs limited activities. In paragraph 28, it is stated that:

> [t]he principles set out in the 1979 OECD report … are valid in these cases. The actual economic function of the base company has to be carefully analysed … Thus, its actual activities, risks and responsibilities have to be ascertained. *Where the base company has no economic functions of its own but serves exclusively to channel assets to, or income through, a low tax area, it would normally not be able to realise profits in acting between independent parties and this would be the guideline in examining its transfer prices. No, or only a minimal, profit might thus be expected to arise to a base company in a low-tax country formally acting as a seller of merchandise produced by the taxpayer to customers outside that country, if the company actually does not carry out the delivery or other substantial commercial activities … A base company with limited functions, responsibilities or risks corresponding to that of a broker, standby or subcontractor could, if acting between independent parties, obtain a profit only for its actual economic contribution and its transfer prices would normally be examined on a cost oriented basis (e.g. based on a fee or on the cost-plus method).* This basis would normally apply where mere marginal or auxiliary activities are exercised by the base company; where such arrangements do not correspond to normal business practice, no additional profit could be attributed to the base company by reference to what, under normal circumstances, would be the exercise of sound commercial judgement, or by reference to a specific allocation mechanism, e.g. the centering of cost-sharing arrangements in the base company. [Emphasis added.]

The report concludes in paragraph 32 that TP rules "are not curtailed by a tax treaty between the country of residence of the taxpayer and the country of the base company. The internationally agreed principles of the 1979 OECD report … provide valid guidelines for an effective application of the arm's length principle in the case of base companies. In any future revision of the OECD Model Convention this aspect might however be stressed in the Commentaries on Article 9". The approach adopted here once again looks into the actual conduct.

In 1992, in order to update its TP guidance, the United States issued proposed treasury regulations to section 482 of the US Internal Revenue Code. Thereafter, in 1993, in response to a public consultation, temporary

50. OECD, *Double Taxation Conventions and the Use of Base Companies* (OECD 1986), Primary Sources IBFD.

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and proposed regulations were issued. These regulations made several changes to the 1968 regulations.[51] One of the most controversial changes pertained to the implementation of the "commensurate with income" standard in the form of periodic adjustment rules with respect to intangibles.

The OECD set up a task force to analyse the draft regulations. Several recommendations were made in a report issued by the OECD Committee on Fiscal Affairs.[52] One of the recommendations, appearing in paragraph 3.18, was "that the alternative business transactions realistically available to the taxpayer not be used to second-guess the appropriateness of bona fide business decisions except where *the transaction lacks economic substance*" [emphasis added]. In addition, it was recommended that "the use of hindsight be eliminated from the risk analysis required by the revised Regulations". On the latter point, in paragraph 2.5 of the report, the task force expressed its view that, "to the extent that the implementation of the commensurate with income standard involves the use of hindsight, there is a risk that the arm's length standard will be violated because the application of the arm's length standard depends on the evaluation of the facts and circumstances surrounding transactions at the time they take place".

In fact, the US regulations, which were published in 1994, made reference to the concept of economic substance on several occasions.[53] Specifically, in section 1.482-1(d)(3)(ii)(B) it is stated:

> The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if *such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties... If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.* [Emphasis added.]

Moreover, with respect to allocation of risks, the regulation in section 1.482-1(d)(3)(iii)(B) states that: "the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected *if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance*" [emphasis added]. Further, in order to determine the allocation of risks in accordance with economic substance, the regulations highlight that it is necessary to determine whether the enterprise (which claims to bear the risk) "has the *financial capacity to fund losses* that might be expected to occur as the result of the assumption of a risk" [emphasis added] and whether the enterprise "*exercises managerial or operational control over the business activities* that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively *more control*" [emphasis added].

Interestingly, with respect to ownership of intangibles, the regulations in section 1.482-4(f)(3) state:

> The legal owner of a right to exploit an intangible ordinarily will be considered the owner … Legal ownership may be acquired by operation of law or by contract under which the legal owner transfers all or part of its rights to another. *Further, the district director may impute an agreement to convey legal ownership if the conduct of the controlled taxpayers indicates the existence in substance of such an agreement.* See § 1.482-1(d)(3)(ii)(B) (Identifying contractual terms). [Emphasis added.]

A cross reference is made to the guidance on risks. Arguably, the statement indicates that if there is a mismatch between the formal agreement and actual conduct then the US Internal Revenue Service (IRS) may impute ownership to an enterprise based on the latter. Additionally, with respect to intra group funding transactions, the regulations in section 1.482-2(a)(3)(i) state that, in determining whether or not loans classify as real loans,

> the substance of the transaction shall be determined; for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply. Only the rate of interest with respect to the stated principal amount of the bona fide indebtedness (within the meaning of paragraph (a)(1) of this section), if any, shall be subject to adjustment under section 482, paragraph (a) of this section, and any other Internal Revenue Code section.

In 1995, the OECD updated its TP guidelines with the release of the OECD Guidelines (1995).[54] These guidelines are a revision of the OECD TP Report (1979). As a starting point, the guidelines state, in paragraph 1.28, that the roles and responsibilities of the parties to a transaction should be determined on the basis of written contracts. This said, the guidelines also provide that it is "important to examine whether the conduct of the parties conforms to the terms of the contract or

51. For background on these proposed regulations, *see* US: Internal Revenue Service (IRS), Intercompany Transfer Pricing Regulations Under Section 482, TD 8552, 59 Fed. Reg. 34971 (8 Jul. 1994), available at https://www.govinfo.gov/content/pkg/FR-1994-07-08/html/94-16456.htm (accessed 15 Oct. 2020).
52. *See* OECD Comm. on Fiscal Affairs, *Intercompany Transfer Pricing Regulations under US Section 482 Temporary and Proposed Regulations* (OECD 1993), para. 3.18, available at http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=OCDE/GD(93)131&docLanguage=En (accessed 15 Oct. 2020).
53. The 1994 US regulations are available at https://www.irs.gov/pub/irs-apa/482_regs.pdf (accessed 15 Oct. 2020).
54. *OECD Guidelines for Multinational Enterprises and Tax Administrations* (OECD 1995), Primary Sources IBFD.

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whether the parties' conduct indicates that the contractual terms have not been followed *or are a sham*. In such cases, further analysis is required to determine the true terms of the transaction" [emphasis added]. With respect to structural adjustments, paragraph 1.37 then discusses the exceptional circumstances[55] in which a tax authority may consider disregarding the structure of a controlled transaction.

The first circumstance arises "where the economic substance of a controlled transaction differs from its form". This is also referred to as "the economic substance exception". An enhanced version of the loan example (originating in paragraph 15 of the WP6 TP Draft (1978)) is used to illustrate its application. In that example, due to the specific circumstances of the borrowing entity, funding via loan is recharacterized as equity. Moreover, in paragraphs 1.26 and 1.27, a discussion is undertaken of whether "a purported allocation of risk is consistent with *the economic substance of the transaction*" [emphasis added]. In this regard, the guidelines (inspired by the US regulations) clearly state that "the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk" and "in arm's length dealings it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively *more control*" [emphasis added]. This discussion once again indicates that the "real deal" needs to be ascertained and that "real deal" needs to be priced to allocate profits to an entity. In ascertaining the "real deal" the focus should be on determining actual conduct. Further, risks should be allocated to an enterprise if it exercises controls over the relevant risks. At this juncture, the reader should note that this discussion was also reflected in paragraphs 65-69 of a Working Party 6 Secretariat Note issued on 21 October 1993 (WP6 Secretariat Note (1993)).[56] In particular, in paragraph 65 it was stated that "[r]estructuring of the controlled transaction generally should not be used to second-guess the bona fide business decisions of the associated enterprises, *except in the case of transactions lacking economic substance*" [emphasis added].

The second circumstance arises where the form and substance (as demonstrated by actual conduct) coincide, but the arrangements made in relation to the transaction:

- differ from those that would have been made between two independent enterprises behaving in a commercially rational manner; and
- the structure impedes the tax authorities from determining an appropriate transfer price.

This circumstance is referred to as "the commercial rationality exception". Both criteria need to be satisfied to fulfil this exception. A sale of IP under a long-term contract is used to demonstrate its application. As the transaction was not commercially rational, the sale is recharacterized as a continuing research agreement. The second exception, in comparison to the first exception, seems not have been discussed in the OECD TP Report (1979) nor the WP6 Secretariat Note (1993). However, this circumstance seems to have been added in the revised version of that Secretariat Note, issued on 26 January 1994.[57] Bullen (2011) has argued that this exception was developed in light of the guidance on the commensurate with income standard in the form of periodic adjustment rules.[58] Additionally, he has extensively analysed the example and has convincingly proved that the transaction is irrational, as it contained a combination of a static pricing mechanism and valuation uncertainty.[59]

Paragraph 1.38 of the OECD Guidelines (1995) states that:

> [i]n both sets of circumstances described above, the character of the transaction may derive from the relationship between the parties … and may have been structured by the taxpayer to avoid or minimise tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length dealings. *Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length*. [Emphasis added.]

With respect to intangibles, the revised OECD Guidelines (1996) contained a reference to the concept of economic ownership without getting into details of the concept. They stated only that:

> [t]rade intangibles often are created through risky and costly research and development (R&D) activities, and the developer generally tries to recover the expenditures on these activities and obtain a return thereon through product sales, service contracts, or licence agreements. The developer may perform the research activity in its own name, i.e. with the intention of *having legal and economic ownership of any resulting trade intangible*, on behalf of one or more other group members under an arrangement of contract research where the beneficiary or *beneficiaries have legal and economic ownership of the intangible*, or on behalf of itself and one or more other group members under an arrangement in which the members involved are

55. Id., at para. 1.37.
56. OECD Comm. on Fiscal Affairs Working Party 6, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Note by the Secretariat)*, DAFFE/CFA/WP6(93)16 (21 Oct. 1993), available at https://www.taxtreatieshistory.org/data/pdf/DAFFE-CFA-WP6(93)16E.pdf (accessed 9 Oct. 2020).
57. OECD Comm. on Fiscal Affairs Working Party 6, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Note by the Secretariat)*, DAFFE/CFA/WP6(93)16/REV1 (26 Jan. 1993), available at https://www.taxtreatieshistory.org/data/pdf/DAFFE-CFA-WP6(93)16rev1E.pdf (accessed 15 Oct. 2020).
58. Bullen, *supra* n. 42, at 514-518.
59. Bullen, *supra* n. 42, at 663-684.

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> engaged in a joint activity and *have economic ownership of the intangible* (also discussed in Chapter VIII on cost contribution arrangements).[60] [Emphasis added.]

Consequently, it could be argued that profits/losses could be attributed to entities within an MNE that have economic ownership of the intangible, that is, entities whose conduct indicates that they developed the intangibles. In this regard, it is interesting to cite the findings of Miyatake (2007), the general reporter to one of the main topics discussed in the 2007 IFA Congress, that is, intangibles. He concluded that "economic ownership appears to be more important than legal ownership. Economic ownership could override legal title if a party without legal ownership had made a significant economic or other contribution to the development of the intangible concerned".[61]

In 2009, the IRS adopted the final regulations under section 482 of the Internal Revenue Code.[62] These regulations, which followed temporary regulations issued in 2006, make several changes to and update the 1994 regulations. With respect to intangible transactions, several modifications were put forward. Section 1.482-4(f)(3) made it clear that "The legal owner of intangible property pursuant to the intellectual property law of the relevant jurisdiction, or the holder of rights constituting an intangible property pursuant to contractual terms (such as the terms of a license) or other legal provision, will be considered the sole owner of the respective intangible property for purposes of this section unless *such ownership is inconsistent with the economic substance of the underlying transactions*" [emphasis added.]. Where the legal owner cannot be identified, the regulations state that "the controlled taxpayer who has *control* of the intangible property, based on all the facts and circumstances, will be considered the sole owner of the intangible property for purposes of this section" [emphasis added].

Returning to the work of the OECD, the discussion in chapter I of the OECD Guidelines (1995) was also reflected in chapter I of the OECD Guidelines (2010). The relevant paragraphs are paragraph 1.53 (checking whether the transaction is a sham), paragraphs 1.65-1.69 (the two exceptions) and paragraphs 1.48 -1.49 (the discussion on allocation of risks in accordance with economic substance).[63] All these points were additionally (and extensively) discussed in chapter IX of the OECD Guidelines (2010), a new chapter that was added pursuant to the OECD Centre for Tax Policy and Administration's Discussion Draft on the Transfer Pricing Aspects of Business Restructurings (OECD 2008).[64]

In an open market, an assumption of a higher level of risk corresponds to a higher level of expected return.[65] Business restructurings are typically accompanied by a reallocation of risks and profits among the members of an MNE group.[66] Such reallocation of risks must be consistent with actual conduct, and chapter IX of the OECD Guidelines (2010) provides guidance to ensure that this consistency is achieved. Accordingly, in part I of chapter IX, with respect to determining whether the allocation of risks in accordance with economic substance, the guidance begins by stating that, if there is reliable evidence that the risk allocation in the controlled transaction (restructuring) is similar to the allocation that would be made between independent parties, then the risk allocation can be considered arm's length.[67] However, in the absence of such evidence, in order to determine whether the risk allocation in a controlled transaction is the same as would have been agreed between independent parties, an analysis should be performed, for each relevant member that is a party to the restructuring, of the "control over risk" and the "financial capacity" to assume that risk. *These two factors are not considered determinative, but merely relevant factors.*[68] Control over risk means the capacity to make the decision to take on the risk and decisions on whether and how to manage the risk (e.g. internally or by outsourcing).[69] This requires that a company must have employees and/or directors with the authority and skills to actually perform the control functions.[70] Three examples are provided to illustrate the concept of control: (i) investor/fund manager;[71] (ii) principal/contract researcher;[72] and (iii) principal/contract manufacturer.[73] The second factor is whether the party to whom the risk is allocated has the financial capacity to assume the relevant risk. This means that, in the event that the risks materializes, the company must have the financial means to bear the consequences[74] (this does not necessarily mean that it would need to bear the full risk, but only that

60. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 1996) para. 6.3, Primary Sources IBFD.
61. T. Miyatake, *General Report*, in *Transfer Pricing and Intangibles* 25-26 (IFA Cahiers vol. 92A, 2007), Books IBFD.
62. *See* US: IRS, Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangible Property; Stewardship Expense; Final Rule, TD 9456, 74 Fed. Reg. 38830 (4 Aug. 2009), available at https://www.govinfo.gov/content/pkg/FR-2009-08-04/pdf/E9-18326.pdf (accessed 15 Oct. 2020).
63. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010), Primary Sources IBFD.
64. OECD Ctr. for Tax Policy and Admin., *Discussion Draft on the Transfer Pricing Aspects of Business Restructurings (19 September 2008-19 February 2009)* (OECD 2008), available at http://www.oecd.org/ctp/transfer-pricing/41346644.pdf (accessed 9 Oct. 2020).
65. Id., at para. 9.10.
66. Id., at para. 9.6.
67. Id., at para. 9.18.
68. Id., at para. 9.20.
69. Id., at para. 23.
70. Id.
71. Id., at para. 9.25.
72. Id., at para. 9.26.
73. Id., at para. 9.27.
74. Id., at para. 9.29.

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the company could protect itself from the risk materialization).[75]

The guidance developed in Part I is discussed again in Part IV, in the context of determining whether or not a restructuring (as put forward by the taxpayer) should be respected. In this regard, it is stated that a restructuring undertaken by an MNE can be challenged under the two exceptions, with the effect that the restructuring may not be recognized.[76]

A situation in which the economic substance exception could apply is demonstrated through an example wherein the legal owner of the intangible was not allocated income derived from the intangible.[77] The example discusses a case in which Co A, which had developed the intangible, had transferred the intangible to a shell entity viz., Co Z. Following the transfer, Co A (through its employees) still carried out activities associated with the development, maintenance and execution of the transferred intangible. Conversely, Co Z had neither employees or directors capable of performing risk control functions in relation to the intangible, nor the financial capacity to assume the risks in connection with the intangible. In this circumstance, the guidelines stated that:

> [a] full consideration of all of the facts and circumstances warrants a conclusion that the economic substance of the arrangement differs from its form. In particular, the facts indicate that Company Z has no real capability to assume the risks it is allocated under the arrangement as characterised and structured by the parties. Furthermore, there is no evidence of any business reasons for the arrangement. In such a case paragraph 1.65 allows a tax administration to not recognise the structure adopted by the parties.

The example is consistent with the idea found in chapter VI[78] that economic ownership should be used to determine the owner of the intangible.

At the same time, the guidance on the commercial rationality exception and the two cumulative criteria for fulfilling it was broadened. With respect to the first criterion, as a start, it was emphasized that, if "reliable data show that comparable uncontrolled transactions exist, it cannot be argued that such transactions between associated enterprises would lack commercial rationality".[79] Also, it is highlighted that, in the assessment of commercial rationality, the considerations of "options realistically available" would also be relevant.[80]In this regard, it is stated that:

An independent enterprise would not enter into a restructuring transaction if it sees an alternative option that is realistically available and clearly more attractive, including the option not to enter into the restructuring. In evaluating whether a party would at arm's length have had other options realistically available to it that were clearly more attractive, due regard should be given to all the relevant conditions of the restructuring, to the rights and other assets of the parties, to any compensation or indemnification for the restructuring itself and to the remuneration for the post-restructuring arrangements.[81]

In relation to the second criterion, it is stated that "[i]f an appropriate transfer price (i.e. an arm's length price that takes into account the comparability – including functional – analysis of both parties to the transaction or arrangement) can be arrived at in the circumstances of the case, irrespective of the fact that the transaction or arrangement may not be found between independent enterprises and that the tax administration might have doubts as to the commercial rationality of the taxpayer entering into the transaction or arrangement, the transaction or arrangement would not be disregarded under the second circumstance in paragraph 1.65".[82]

The 2013 version of the UN Manual,[83] which essentially follows the OECD framework, also states in paragraph 5.3.2.31 that "it is important to figure out whether the contractual terms between the associated enterprises are a 'sham' (something that appears genuine, but when looked at more closely lacks reality, and is not valid under many legal systems) and/or have not been followed in reality". Moreover, both exceptional circumstances are discussed in paragraph 5.3.1.4. Furthermore, it also makes reference to the concept of economic ownership vis-à-vis intangibles in paragraph 5.3.2.15. Interestingly, the South African experience on the concept of economic ownership needs to be highlighted here. The discussion deals with a case in which a South African entity that has developed intangibles transfers those intangibles to a related entity outside South Africa. The related entity, which legally owns the intangibles and performs limited functions, receives royalty income, even though all further R&D related work is carried out in South Africa, for which the South African entity earns a cost-plus return. The question then is "can the South African entity be considered to have economic ownership?". In paragraph 10.5.5.4, the tax administration argues that "from the perspective of the SARS [i.e. the tax administration] there is merit in the argument that economically the ownership resides with the South African entity and as such the entity should be earning

75. Id., at para. 9.32.
76. Id., at para. 9.169.
77. Id., at paras. 9.190-9.192.
78. Id., at para. 6.3.
79. Id., at para. 9.172.
80. Id., at para. 9.175.
81. Id., at para. 9.176.
82. Id., at para. 9.180.
83. *UN Practical Manual on Transfer Pricing for Developing Countries* (UN 2013), available at https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-03/UN_Manual_TransferPricing.pdf (accessed 6 Nov. 2020).

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an intangible related return. Given the true functional and risk profile of the related party, the related party should be compensated as a service provider for registration and maintenance of the intangible property".

Following BEPS Actions 8-10, the economic substance exception has been deleted and has been integrated into the broader concept of accurate delineation of the controlled transaction. Paragraph 1.45 of the OECD Guidelines (2017) provides that, "if the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated enterprises, the actual transaction should generally be delineated for purposes of the transfer pricing analysis in accordance with the characteristics of the transaction reflected in the conduct of the parties."[84] Additionally, in paragraph 1.46 it is stated that:

> [i]t is, therefore, particularly important in considering the commercial or financial relations between associated enterprises to examine whether the arrangements reflected in the actual conduct of the parties substantially conform to the terms of any written contract, *or whether the associated enterprises' actual conduct indicates that the contractual terms have not been followed, do not reflect a complete picture of the transactions, have been incorrectly characterized or labelled by the enterprises, or are a sham.* Where conduct is not fully consistent with economically significant contractual terms, further analysis is required to identify the actual transaction. Where there are material differences between contractual terms and the conduct of the associated enterprises in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, *should ultimately determine the factual substance and accurately delineate the actual transaction.* [Emphasis added.]

Preference for factual substance is also highlighted in paragraph 1.120. As the guidance focuses on actual conduct of the parties, chapter I of the OECD Guidelines (2017), inspired by the work in chapter IX of the OECD Guidelines (2010), provides a framework for analysing risks in order to accurately delineate the controlled transaction. The OECD Guidelines (2010) provide, in paragraph 1.60, that returns will be allocated to an entity that bears the associated risks. Specifically, the guidelines as updated in 2017 state that the risks and returns should be allocated to the entity that controls the risk and has the financial capacity to bear the risk. Detailed guidance is then provided on these requirements (paragraphs 1.66-1.106). *These criteria now seem to be determinative criteria.*

In light of the guidance in chapter I, chapter VI of the OECD Guidelines (2017) was expanded: in particular, the guidance on "ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles". In fact, with respect to intangibles, several examples in the annex to chapter VI allocate income to an entity that has demonstrated economic ownership (taxpayers who have carried out development activities). This said, the guidance no longer uses the words "economic ownership".

The "commercial rationality exception" has been retained in paragraphs 1.122-1.24. In particular, paragraph 1.122 now frames this test in a different manner compared to the previous versions of the guidelines. It is now stated that:

> [t]he transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the:
>
> – arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances,
>
> – thereby preventing determination of a price that would be acceptable to both of the parties taking into account
>
>   – their respective perspectives; and
>
>   – the options realistically available to each of them at the time of entering into the transaction.

Moreover, it is stated that "it is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a pre-tax basis since this may be an indicator that the transaction viewed in its entirety lacks the commercial rationality of arrangements between unrelated parties".

These changes seem to be partly inspired by the work done in chapter IX of the OECD Guidelines (2010). Two examples are provided to illustrate its application. The first example (paragraphs 1.126-1.127) deals with an insurance (probably a captive insurance) case wherein the transaction is not recognized, with the effect that the payer of the insurance premium is denied the deduction and the income is not taxed at the level of the recipient. The second case (paragraph 1.128), inspired by previous versions of the OECD Guidelines, deals with the sale of an intangible for a lump sum payment that could be recharacterized, depending on the facts, as:

– the provision of financing, with the effect that the transferor (S1) and not the funder (S2) retains substantial profits (*see* section 4.);
– the provision of research services by S1, on the assumption that S2 has the appropriate staff to perform the key DEMPE functions; or
– if specific intangibles can be identified, as a licence with contingent payment terms for the development of those specific intangibles (taking into account the guidance on hard-to-value intangibles (HTVIs)).

84. *OECD Guidelines* (2017), *supra* n. 2, at para. 1.45.

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The UN Manual (2017) follows the OECD Guidelines.[85] According to paragraph B.2.3.1.4 of the UN Manual, a controlled transaction should be delineated on the basis of actual conduct. Moreover, in paragraph B.2.3.1.5 it is stated that tax authorities should be able to disregard a controlled transaction only in "exceptional circumstances".[86] Such an exceptional circumstance may exist if the transaction is not commercially rational, with the result that an appropriate transfer price for each party to the transaction cannot be determined (taking into account their own perspectives and the options realistically available to each of them).[87] A test for commercial rationality should be conducted from each entity's own perspective, as an arrangement that is commercially rational at group level might not be at arm's length from the perspective of the two parties to the transaction.[88] Moreover, unlike the OECD Guidelines, the UN Manual (2017) clearly states that article 9 does not set out detailed TP rules. Essentially, whether a tax authority has the ability to disregard or even substitute a controlled transaction depends on the relevant provisions in domestic law, and should be considered in developing countries' domestic TP legal framework.[89] With respect to intangibles, detailed guidance is provided in the UN Manual on economic ownership, in particular, on the "DAEMPE" concept, where the additional "A" stands for acquisition of the intangible (paragraphs B.5.3.1-B.5.3.36).

3.3. The authors' perspective

3.3.1. Application of domestic sham doctrine

At the outset, it is important to state that tax treaties do not create taxing rights. This means that tax authorities are not allowed to adjust the structure of the transaction unless authorized by domestic law.[90] At the same time, tax treaties (including article 9) can restrict the application of national law.[91] In order to apply the arm's length principle (ALP), it is necessary, firstly, to determine the controlled transaction, and then, secondly, to carry out a comparability analysis. Thus, the first step deals with establishing the facts of the transaction or determining the controlled transaction that needs to be priced.[92] In other words (as provided by article 9), this means identifying the "conditions … made or imposed between two associated enterprises in their commercial or financial relations". With respect to the first step, the question arises of whether article 9 restricts the application of national law measures which, when applicable, could look beyond legal arrangements and identify "commercial or financial relations" based on underlying reality or actual conduct.

Naturally, tax law (including TP rules), should apply to the real facts of a case. Accordingly, tax treaties (including article 9) do not restrict the application of domestic fact-finding rules or doctrines.[93] In this regard, the sham doctrine stands out as an important doctrine, as reference to it has been made in various versions of the OECD Guidelines and UN Manual. While discussing this doctrine in detail is beyond the scope of this contribution,[94] a high-level overview will be provided of the application of this doctrine in a Canadian and US context.

Inspired by the UK case *Snook* (1967)[95] the concept of sham has been discussed by the Supreme Court of Canada in several cases, such as *Cameron* (1972),[96] *Stubart Investment* (1984)[97] and *McClurg* (1990)[98] and, more recently, by the Tax Court of Canada (TCC) in *Lee* (2018)[99] and *Cameco* (2018).[100] From these decisions, it can be ascertained that a "sham" must be intentional (the parties to the sham must jointly intend to create the appearance of legal rights or a relationship that differs from the actual rights or relationship) and must be undertaken to deceive a third party. The element of deceit, i.e. the presence of a common intention to create the appearance of a legal result different from the actual legal result, is, therefore, necessary for a transaction to qualify as a sham. If the doctrine applies, then the tax treatment will be determined in accordance with the correct legal facts as opposed to those set out in documents.[101]

In fact, the *Cameco* case dealt with the application of the Canadian sham doctrine/TP rules to a commodity trading structure. At the core, and on the basis of a highly simplified fact pattern, a Canadian parent (taxpayer) had shifted its uranium trading business to European establishments – specifically, to the Swiss branch of a Luxembourg subsidiary (CESA), which was later converted to a Swiss subsidiary (CEL). CESA/CEL had a few employees who were involved in carrying out the core trading operations. Essentially, the European establishments entered into contracts with third parties and the taxpayer (and its other associated

85. *UN Manual* (2017), *supra* n. 37.
86. Id., at para. A.4.6.
87. Id., at para. B.2.3.1.5.
88. Id., at para. B.2.3.1.6.
89. Id., at para. B.2.3.1.9.
90. Bullen, *supra* n. 42, at 75-76.
91. Id., at 68-74.
92. *OECD Guidelines* (2017), *supra* n. 2, at para. 1.33.
93. Bullen, *supra* n. 42, at 146-147.
94. For a detailed analysis, *see* Chand, *supra* n. 40, at ch. 3.
95. UK: EWCA Civ, 17 Jan. 1967, *Snook v. London & West Riding Investments Ltd*, 1 All ER 518, 528.
96. CA: SCC, 29 June 1972, *Minister of National Revenue v. Cameron*, [1974] SCR 1062, 1068-1069.
97. CA: SCC, 7 June 1984, *Stubart Investments Ltd v. Her Majesty the Queen*, 1 SCR 536.
98. CA: SCC, 20 Dec. 1990, *McClurg v. Minister of National Revenue*, [1990] 3 SCR 1020.
99. CA: TCC, 15 Nov. 2018, *Lee v. Her Majesty the Queen*, [2018] TCC 230, paras. 48-73.
100. Paras. 582-670 *Cameco* (2018).
101. B. Beswick & A. Nijhawan, *Canada*, in *Anti-Avoidance Measures of General Nature and Scope – GAAR and Other Rules* 22 (IFA Cahiers vol. 103A, 2018), Books IBFD.

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enterprises). According to the contracts, CESA/CEL bought uranium mostly from independent parties and then sold the uranium to their related parties, which then sold the items to independent clients. By doing so, the related parties received compensation from the clients and then, after retaining a commission fee, passed on the bulk of the income to the European establishments. Consequently, profits were accumulated in the European establishments (in particular, the Swiss subsidiary).

First, the minister challenged the taxpayer's structure using the sham doctrine and not the Canadian TP rules. However, Justice Owens concluded in paragraph 670 that, "[i]n summary, I find as a fact that the Appellant, Cameco US and CESA/CEL did not factually represent the numerous legal arrangements that they entered into in a manner different from what they knew those arrangements to be, nor did they factually represent the transactions created by those arrangements in a manner different from what they knew those arrangements to be, consequently, the element of deceit required to find sham is simply not present".

In the context of IP arrangements, consider the following hypothetical case. Co R from Country R develops a trade intangible, among several intangibles. Co R agrees to license the intangibles to related Co S in Country S pursuant to a written contract. Co S makes a royalty payment. On investigation by the Country S tax administration, the facts indicate that the IP was never transferred to Co S and that Co S never benefited from such IP. In this situation, the tax administration of Country S could apply the sham doctrine, with the effect that the deduction would be disallowed to Co S.[102] The sham doctrine is applicable as there is an element of "falsity" or "deceit" or "lies".

At the same time, the concept of sham is quite broad in the United States. A sham can be either a sham in fact or a sham in substance.[103] A factual sham arises where the transactions reported by the taxpayer never occurred or were created on paper but never actually took place. If the doctrine applies, then the transactions reported by the taxpayer will be considered non-existent for tax purposes[104] (seemingly similar to the Canadian approach). On the other hand, a sham in substance (or economic sham) arises when the purported transaction does not have any underlying economic substance and is undertaken solely to achieve a reduction in tax.[105] Consequently, the sham in substance doctrine provides that, in the United States, a transaction will be respected for tax purposes and will not be considered as a sham if it has underlying economic substance.[106] Accordingly, depending on the jurisdiction, the sham doctrine (understood in a broad sense) could overlap with other rules, such as domestic TP rules or general anti-abuse rules (GAARs).

3.3.2. Application of domestic TP rules

3.3.2.1. Accurate delineation of the transaction (also the dealing) based on actual conduct

3.3.2.1.1. In the context of article 9

As stated by the OECD Guidelines (2017), "before making comparisons with uncontrolled transactions, it is... vital to identify the economically relevant characteristics of the commercial or financial relations as expressed in the controlled transaction". Accordingly, in addition to the contractual terms of the transactions, other economically relevant factors need to be considered – in particular, a functional analysis.[107]

National TP rules typically require the performance of a functional analysis. Examples include (i) the US TP rules contained in section 482 of the Internal Revenue Code; (ii) the Australian TP rules in Division 815 of the Australian Income Tax Assessment Act, 1997;[108] (iii) the Dutch TP rules in section 8b of the Dutch Corporate Income Tax Act, 1969;[109] and (iv) the Canadian TP rules in section 247 of the Canadian Income Tax Act, 1998.[110] If the functional analysis indicates a divergence between the contractual terms and actual conduct, then the controlled transaction needs to be determined on the basis of the latter.[111] Accordingly, when the domestic tax administration determines the commercial and financial relations of the controlled transaction based on *actual reality*, then it cannot be argued that article 9 restricts such domestic fact-finding rules that establish the true content of the structure/transaction.

102. Bullen, *supra* n. 42, at 162.
103. H. Lee & C. Turner, *United States*, in *Anti-Avoidance Measures of General Nature and Scope – GAAR and Other Rules* 15-16 (IFA Cahiers vol. 103A, 2018), Books IBFD.
104. P.W. Streng & D.L. Yoder, *United States*, in *Form and Substance in Tax Law* 596 (IFA Cahiers vol. 87A, 2002), Books IBFD.
105. Id., at 597.
106. Id., at 610.
107. *OECD Guidelines* (2017), *supra* n. 2, at para. 1.36.
108. *See* AU: Income Tax Assessment Act, 1997, division 815, Primary Sources IBFD; also available at https://www.legislation.gov.au/Details/C2013C00670/af5510d6-e678-40aa-9523-d88abad32e72 (accessed 15 Oct. 2020).
109. *See* NL: Ministry of Finance Decree 2018-6865 (22 Apr. 2018), available at https://www.government.nl/documents/decrees/2014/03/25/ifz2013-184m-international-tax-law-transfer-pricing-method-application-of-the-arm-s-length-principle-and-the-transfer-pricing-g (accessed 15 Oct. 2020).
110. *See* CA: Income Tax Act, 1998, sec. 247, Primary Sources IBFD; also available at https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/ic87-2/international-transfer-pricing.html#P154_12171 (accessed 15 Oct. 2020); and CA: Canada Revenue Agency [CRA], *2010 Update of the OECD Transfer Pricing Guidelines* (31 Oct. 2012; last updated 24 Apr. 2020), available at https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/information-been-moved/transfer-pricing/14-2010-update-oecd-transfer-pricing-guidelines.html (accessed 15 Oct. 2020) [hereinafter *2010 Update*].
111. *OECD Guidelines* (2017), *supra* n. 2, at paras. 1.45 and 1.48.

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Arguably, such *actual reality* could also be determined by applying one of the exceptional circumstances, that is, the "economic substance" exception. Bullen (2011) has extensively analysed the economic substance exception contained in the OECD Guidelines (1995/2010) and in the US Treasury Regulations, and has remarked that this exception created a lot of confusion as its boundaries were not clearly defined. He argued that the economic substance exception contained a factual substance prong and an arm's length prong.[112] Adjustments made under the factual substance prong (evidenced by actual conduct) cannot be restricted by article 9, as they determine the "real" commercial and financial relations of the associated enterprises.[113] The present authors agree with this line of reasoning.

At the same time, Bullen (2011) argues that the economic substance exception deals only with the "arm's length prong",[114] which mainly targets risk reallocations (mostly done pursuant to applying the "control" or "financial capacity" concepts).[115] His view is that article 9 allows such reallocations. This would mean that risk reallocations carried out under for example, national TP rules based on the ALP will not be prohibited. Ultimately, it is the present authors' understanding that Bullen argued for the deletion of the economic substance exception due to its wide scope, and proposed that (i) the concept of "factual substance" needs to be introduced in chapter I; and that (ii) risk reallocations under the arm's length prong could be addressed under the second exceptional circumstance, which deals with commercial rationality.[116]

It seems that the OECD has partly followed this recommendation in the OECD Guidelines (2017). These introduced the concept of factual substance in paragraphs 1.46 and 1.120, while at the same time the economic substance exception was deleted. However, the arm's length prong (which deals mainly with risk reallocation) has been included under the broad concept of accurately delineating the transaction. One may raise the question (by referring to the wording of article 9) of whether the arm's length prong can be used to establish the conditions "made or imposed between two associated enterprises in their commercial or financial relations", or whether the prong should be used only once the "commercial or financial relations" have been established and where those relations "differ from those which would be made between independent enterprises". In the view of the present authors, drawing a borderline is challenging. The arm's length prong can be used to establish the controlled transaction as well as to determine the price due to the fact that the analysis is intertwined.[117] To this end, the present authors agree with the statement provided in the OECD Guidelines (2017), that "[e]conomically relevant characteristics or comparability factors are used in *two separate* but related phases in a transfer pricing analysis".[118] This conclusion seems consistent with the OECD Guidelines (1995/2010) as well as with the US Treasury Regulations (1994), which sought to check whether the contractual allocation of risk is consistent with *the economic substance of the transaction* determined by actual conduct.

Accordingly, the focus on actual conduct (established through a functional analysis)[119] is extremely important, especially with respect to risk allocations, as the ALP is based on the principle that the greater the risks borne by the establishment, the higher the potential return (positive or negative).[120] In other words, if the contractual allocation of economically significant risks to an establishment in an MNE is not consistent with the actual conduct, the latter should prevail. In this regard, the concepts of "control over risk" and "financial capacity" to bear the risks, which in the authors' opinion are sound criteria,[121] are crucial in determining which establishment in practice bears the economically significant risk.[122] The application of these concepts, illustrated through a six-step framework,[123] seems to have originated in the US regulations and then, in one way or another, to have found its way into the OECD Guidelines and UN Manual. In the present authors' opinion, independent parties *in most circumstances* bear risks when they can "control" them or "financially" bear them, or a combination of both. Accordingly, these additions to the OECD Guidelines are clarificatory in nature and can be applied to tax treaties concluded before or after the BEPS project.

In the *Cameco* case discussed in section 3.3.1., price risk was identified as an economically significant risk. The question arose as to which party bore this risk: that is, the taxpayer or the Swiss subsidiary? The tax administration argued that this risk was borne by the taxpayer (parent), and that it should be entitled to residual profit, whereas the Swiss subsidiary should be characterized as a limited-risk entity and thus be entitled to lower profits. In this regard, the TCC, taking into consideration the Swiss subsidiary's functional profile, stated in paragraph 838 of the judgment that:

> Of course, contractual terms may not always reflect the economic substance of an arrangement, which may in turn warrant a transfer pricing adjustment. In this case, CESA/CEL entered into a number of contracts for the purchase of uranium. In doing so, CESA/CEL took

112. Bullen, *supra* n. 42, at 147-150.
113. Id., at 150-162.
114. Id., at 442-450.
115. Id., at 461.
116. Id., at 737-738.
117. Paras. 749-750 *Cameco* (2018).
118. *OECD Guidelines* (2017), *supra* n. 2, at paras. 1.37-1.38.
119. Id., at paras. 1.51-1.55.
120. Id., at para. 1.56.
121. *See* Bullen, *supra* n. 42, at 482-484 and 499-501.
122. *OECD Guidelines* (2017), *supra* n. 2, at paras. 1.64 and 1.65.
123. Id., at paras. 1.56-1.106.

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> on the price risk associated with its ownership of the uranium acquired under those contracts.

The statement indicates that, as long as contractual risk allocations are aligned with economic substance, the transaction cannot be challenged at this stage of the TP analysis. The Federal Court of Australia also arrived at a somewhat similar conclusion in *Glencore* (2019).[124] In that case, based on a highly simplified fact pattern, Glencore Australia sold copper concentrate to its Swiss parent under a "price sharing agreement" (PSA) entered into in 2007. The Australian tax administration challenged the PSA and, as a result, the transaction sales price, under Australia's (former) TP rules. In particular, they argued that an independent mine producer with Glencore Australia's characteristics would not have agreed to the PSA at all. However, in paragraph 319 of the judgment, referring to the exceptional circumstances set out in the OECD Guidelines (1995), the Court held that:

> [t]he present case is not a case falling within either of the exceptions referred to in the 1995 Guidelines. The economic substance of what the parties transacted does not differ from the legal rights and obligations created by the February 2007 Agreement and there was no suggestion at all that tax considerations, rather than normal commercial conditions, shaped the terms of the Agreement such that it can be said that the totality of the terms derived from the relationship of the parties and "the actual structure practically impedes the tax administration from determining an appropriate transfer price".

In fact, the TCC's verdict in the *Cameco* judgment was cited several times by the Federal Court of Australia (paragraph 325 onwards). That said, it must be acknowledged that the six-step framework contained in chapter I of the OECD Guidelines raises several issues and that, in some situations, enterprises could bear risks which they do not control.[125]

With respect to ownership of intangibles, the OECD Guidelines (1979) focused on determining the underlying reality of the transaction. The OECD Guidelines (1995) and (2010) used the term "economic substance" in chapter I and the term "economic ownership" in chapter VI. Economic ownership, in the opinion of the present authors, was linked to economic substance (activity-based concept). This meant the owner of the intangible for TP purposes is the taxpayer who, based on actual conduct, controlled key risks with respect to those assets. In the words of the OECD Guidelines (2017), this would be the party controlling key DEMPE risks, which can be determined by applying the six-step framework vis-à-vis intangibles (*see* section 2.). Accordingly, in the present authors' view, these additions to the OECD Guidelines are also clarificatory in nature and are applicable to tax treaties concluded before or after the BEPS project. Several examples in the annex to chapter VI illustrate this conclusion. For instance, examples 1 to 3 deal with situations in which the transactions, as structured by the associated enterprises, are accurately delineated as a patent administration services contract in light of the actual conduct. Example 15 deals with a scenario in which the actual conduct demonstrates that Company S, and not Shuyona, should receive the proceeds from exploitation of the intangibles.

It may be concluded from the above discussion that national TP rules that determine the controlled transaction on the basis of actual conduct are not restricted by article 9. In other words, under step 1 of the TP analysis (step 2 being the undertaking of a comparability analysis), contractual terms, the conduct of the parties and the allocation/reallocation of the risks have to be considered together in order to delineate the controlled transaction. Consequently, national TP rules that allocate ownership of the intangible to the economic owner/party performing and controlling key DEMPE risks are not restricted by article 9.[126]

In this regard, quite recently, the Swiss *Bundesgericht/Tribunal fédéral* (Federal Supreme Court), in Decision 2C_11/2018,[127] upheld that intangible income should be allocated to the economic owner. In the case at stake, a Dutch company had entered into two contracts: first, an R&D services agreement whereby a French entity provided research services; and, second, a licence agreement with a Swiss entity whereby the latter exploited the research results. In consideration, the Swiss entity paid a royalty to the Dutch entity. After examining all the facts of the case, the Court ruled that the Dutch company did not have the required economic substance to entitle it to a royalty return: in particular, it lacked appropriate personnel. In fact, in the Court's opinion, the appropriate decision-making personnel were employed by the Swiss entity.[128] The Court held, in paragraph 7.6, that:

> *[i]l ressort en effet de l'arrêt attaqué que la société mère n'intervenait pas dans l'activité de recherche et de développement du groupe, qu'elle ne disposait pas de personnel qualifié dans ce domaine et n'avait d'ail-*

124. AU: FCA, 3 Sept. 2019, *Glencore Investment Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia*, [2019] FCA 1432, Case Law IBFD.
125. Collier & Andrus, *supra* n. 35, at para. 4.81.
126. On this point, *see also* J.S.Wilkie, *Transfer Pricing Aspects of Intangibles: The License Model*, 80-83 in *Transfer Pricing in a Post-BEPS World* (M. Lang, R. Petruzzi & A. Storck eds., Kluwer Law International 2016); Screpante, *supra* n. 6, at sec. 6.4; and O. Torvik, *Transfer Pricing and Intangibles* 597-606 (IBFD 2018).
127. CH: Bger/TF [Federal Supreme Court], 10 Dec. 2018, Decision 2C_11/2018, available at: https://www.bger.ch/ext/eurospider/live/fr/php/aza/http/index.php?highlight_docid=aza%3A%2F%2F10-12-2018-2C_11-2018&lang=fr&type=show_document&zoom=YES& (accessed 20 Oct. 2020).
128. For a summary of this judgment, *see* C. Colling-Russo & R. Matteotti, *Swiss tax audits pivot to intellectual property*, Intl. Tax Rev. 32-36 (2019), available at https://www.taxpartner.ch/resources/Matteotti_Colling-Russo_Swiss-tax-audits-pivot-to-IP_ITR_March-2019.pdf (accessed 20 Oct. 2020).

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leurs aucun employé à plein temps jusqu'en 2007 et qu'un nombre moyen de trois employés en 2010 et 2011. C'est en revanche la recourante qui prenait les décisions stratégiques liées à cette activité. Elle employait la direction générale du groupe, dont le directeur de la recherche et du développement, et donnait les instructions à la société française qui avait un rôle d'exécutant... Dans ces circonstances, il n'était donc pas insoutenable de s'écarter des accords contractuels, en estimant que ceux-ci ne correspondaient pas à la réalité économique (concernant l'importance de l'analyse fonctionnelle en matière de comparabilité et les possibilités pour l'administration fiscale de s'écarter de la structure adoptée par le contribuable".

In delivering its judgment, the Court referred to the exceptional circumstances set out in the 1995 and 2010 versions of the OECD Guidelines. A similar outcome would have resulted had the Court referred to the key DEMPE functions concept.

3.3.2.1.2. In the context of article 7

Moving to an article 7 context, under article 7(2) of the OECD Model (2010/2014/2017), the profits attributable to the PE are those that the PE would have earned if acting on an arm's length basis.[129] A two-step approach, also known as the authorized OECD approach (AOA), is provided for determining the profits attributable to a PE.[130] The first step is to carry out a functional and factual analysis to hypothesize the PE.[131] The second step is to price the dealing with the associated enterprise(s) by reference to TP principles.[132] These steps are similar to the steps required under an article 9 analysis.

Specifically, the first step entails understanding the activities carried out by the PE (taking into account its significant people functions, assets and risks) and its dealings with associated enterprises, including the head office. In an intangibles context, if the first step shows that the personnel in the PE are making key development functions-related decisions associated with certain intangibles, then substantial/residual profits related to those intangibles can be allocated to the PE. This was a point of contention in the recent Apple case.

On 15 July 2020, the General Court of the European Union (GCEU) issued its judgment in a tax State aid case in Ireland involving Apple Inc., the US technology group ("the Apple judgment").[133] This judgment annulled the decision taken by the European Commission (EC) on 30 August 2016 ("the Apple decision") with respect to a State aid investigation into the Irish tax rulings granted to Apple, which ordered Ireland to recover EUR 13 billion of illegal State aid granted to two Apple group subsidiaries, Apple Sales International (ASI) and Apple Operations Europe (AOE), both incorporated in Ireland but not tax resident in Ireland as they were managed and controlled abroad. Each of the above subsidiaries had a branch in Ireland.

By relying on two tax rulings obtained from the Irish tax authorities in 1991 and 2007 (applicable up until 2007 and 2014 respectively), Apple could allocate the IP rights to manufacture and sell Apple products in markets outside the Americas, and consequently the profits in connection with those IP rights, to the head offices of ASI and AOE, which were not tax resident anywhere[134] (rather than to the taxable local branches in Ireland).

In this case, the EC determined that the profits from the IP rights should have been allocated to the Irish branches, as the head offices holding the IP rights were not actually based in any country (they were stateless) and had no employees or substance, as opposed to the Irish branches which had some substance. Hence, the EC argued that all profits from IP rights should have been allocated to the Irish branches and should have been subject to corporate tax in Ireland. On the contrary, according to Apple only a small part of those profits should have been allocated to the Irish branches, which only performed low-value-adding functions.

The GCEU approved the EC's use of the arms' length standard developed in the OECD Guidelines to assess whether there was a selective advantage in the application of the TP rules by a Member State (in this case, Ireland). This was a reaffirmation of statements already provided in other State aid judgments.[135] However, the GCEU also highlighted that, in assessing tax State aid cases, the use of the OECD ALP as a benchmark is contingent upon (i) the use of either that method or a similar market standard by the Member

129. OECD Ctr. for Tax Policy & Admin., *2010 Report on the Attribution of Profits to Permanent Establishments* Part I, para. 8 (OECD 2010), Primary Sources IBFD [hereinafter *OECD 2010 Report*].
130. Id., at Part I, para. 10.
131. For a detailed analysis of this step, *see* id., Part I, paras. 57-182.
132. For a detailed analysis of this step *see* id., at Part I, paras. 183-223.
133. IE: GCEU, 15 July 2020, Joined Cases T-778/16, *Ireland v. European Commission*, and T-892/16, *Apple Sales International and Apple Operations Europe v. European Commission*, ECLI:EU:T:2020.
134. This was possible due to the Irish corporate tax residency rules applicable until 2015, which allowed Irish incorporated entities that were managed and controlled outside Ireland not to be subject to tax in Ireland. In such a case, if the jurisdiction where the company was managed and controlled applied tax residency only on the basis of the incorporation criterion, this could result in a company being "stateless" for tax purposes.
135. *See* LU: GCEU, 24 Sept. 2019, Joined Cases T-755/15, *Grand Duchy of Luxembourg v. European Commission*, and T-759/15, *Fiat Chrysler Finance Europe v. European Commission*, ECLI: EU:T:2019:670; and NL: GCEU, 24 Sept. 2019, Joined Cases T-760/15, *Netherlands v. European Commission*, and T-636/16, *Starbucks and Starbucks Manufacturing Emea v. European Commission*, ECLI: EU:T:2019:669.

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State;[136] and (ii) a proper application of the ALP and the OECD Guidelines, i.e. one that considers the actual facts and circumstances and includes an in-depth analysis of functions, risks and assets.

Moreover, the GCEU recognized that Ireland's profit attribution rule for branches (section 25 of the Taxes Consolidation Act, 1997)[137] was sufficiently similar to the ALP, and to the rules included in the OECD Guidelines providing guidance on its application, as to justify the EC's use of the arm's length standard as a benchmark for checking Ireland's profit allocation.[138] In addition, the GCEU also approved the use of the AOA applied in the attribution of profits to PE for the purpose of evaluating the split/allocation of the profits between the Irish branches and the head offices of ASI and AOE. Essentially, GCEU concluded that there was some "overlap" between the AOA and the approach taken under Irish domestic law to attributing profits to a branch (under section 25 of TCA 97).[139]

Nevertheless, the GCEU ultimately annulled the Apple decision because it concluded that the EC, in the Apple's decision primary line of reasoning, failed to prove that the functions, risks and assets related to the relevant IP rights were economically managed and controlled by the Irish branches and, thus, that all profits from those intangibles should have been allocated to the branches. According to the GCEU, the assessment by the EC was based on a misapplication of the AOA and/or section 25 of TCA 97.[140]

Indeed, both the AOA and the Irish rules require an analysis of the actual functions performed, assets used and risks assumed by the branches.[141] Instead of this, the EC based its conclusions on the reasoning that, as the head offices of ASI and AOE had no substance and employees, they could not have performed any functions, controlled any assets or managed any risks, and, consequently, all profits in connection with the IP rights must have been allocated by default to the Irish branches.[142] However, this allocation, based on an "exclusion approach", was supported by neither Irish law nor OECD guidance.[143]

In order to prove that profits from the IP rights should have been attributed to the branches, the EC should have looked at the branches in an affirmative way and substantiated in detail all the functions and activities of those branches that could justify the allocation of all profits derived from the IP rights to them.[144] The GCEU accepted Ireland's and Apple's arguments by recognizing that the place where the strategic decisions were taken and key functions were performed in relation to the IP rights was outside of Ireland, and, more precisely, at the company headquarters in Cupertino in the United States.[145] Thus, the residual profits from the IP rights were not attributable to the Irish branches. A recent press release indicates that the EC will appeal to this decision before the Court of Justice of the European Union.[146] If the EC wants to succeed in ensuring that Ireland should indeed be allocated IP-related profits, the present authors suggest that they take a deep dive into the functional profile of the Irish branches and check if any strategic decisions were made in Ireland (with respect to either DEMPE activities or funding-related activities).

The Apple judgment also includes other arguments in which GCEU dismisses the lines of reasoning of the EC in the Apple decision. However, the present paper does not cover those aspects and focuses only on the main aspect, which is the analysis of the DEMPE functions in relation to valuable intangibles – in this specific case, in the context of the application of the AOA. In the Apple judgment, the GCEU confirmed also in this context, and in line with the Irish tax rules applicable to the State aid case, the importance of a proper analysis of the DEMPE functions and risks in order to determine where the residual returns deriving from the valuable intangibles should be taxable. Although in the Apple judgment the GCEU does not clearly mention the DEMPE acronym, on multiple occasions there are references to strategic development, marketing, R&D and maintenance functions as well as to product development, product quality and market development risks.[147]

3.3.2.2. Recharacterizing or disregarding the delineated transactions under the commercial rationality exception

Once the real transaction is accurately delineated, it may nevertheless be disregarded or recharacterized if it lacks commercial rationality, as explained in the various versions of the OECD Guidelines. Once again, as a starting point, the authority to disregard or recharacterize the controlled transaction under this exception needs to stem from national TP law. It seems that this power is available (to different extents) under, for

136. On this point, *see* R. Mason & S. Daly, *State Aid: The General Court Decision in Apple*, Tax Notes Intl. 1324-1325 (7 Sept. 2020).
137. IE: Taxes Consolidation Act, 1997, sec. 25, Primary Sources IBFD.
138. Mason & Daly, *supra* n. 136, at 1324.
139. Paras. 239-240, *Ireland v. European Commission* (2020).
140. Id., at paras. 241-245.
141. Mason & Daly, *supra* n. 136, at 1324.
142. Id.; and para. 178 *Ireland v. European Commission*.
143. Para. 361 *Ireland v. European Commission*.
144. Mason & Daly, *supra* n. 136, at 1323.
145. Paras. 298-302 *Ireland v. European Commission*, with an emphasis on paras. 300 and 302.
146. *See* European Commission, *Statement by Executive Vice-President Margrethe Vestager on the Commission's decision to appeal the General Court's judgment on the Apple tax State aid case in Ireland*, Press Release (25 Sept. 2020), available at https://ec.europa.eu/commission/presscorner/detail/en/statement_20_1746 (accessed 5 Nov. 2020).
147. For example, para. 341 *Ireland v. European Commission*.

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example, (i) section 247(2)(b) and (d) of the Canadian Income Tax Act, 1998;[148] (ii) Dutch TP law;[149] and (iii) section 815-130 of the Australian TP rules.[150] That said, the national guidance of these countries indicates that both of the exceptional circumstances set out in the OECD Guidelines (1995/2010) (i.e. economic substance and commercial irrationality) could be analysed under their national provisions.

Naturally, the question arises of whether article 9 restricts the application of domestic TP rules that make structural adjustments based on the commercial rationality exception. With respect to this question, the *Cameco* judgment is of great interest. Under section 247(2)(b) of the Canadian Income Tax Act, a structural adjustment can be made if the transaction or series of transactions (i) "would not have been entered into by persons dealing at arm's length" and if it (ii) "can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit". The tax administration applied this two-prong provision to the taxpayer (the Canadian parent), and argued that the profits of the Swiss subsidiary should be reallocated to the taxpayer, as independent enterprises would never enter into such agreements. However, the TCC ruled against the tax administration. Specifically, it stated that, while the conditions of section 247(2)(b)(ii) seemed to be satisfied, as the main purpose of the arrangement was to obtain a tax saving,[151] the provisions of section 247(2)(b)(i) were not satisfied. Only key points of the judgment will be discussed henceforth.

With respect to the provision, as a start, the TCC remarked in paragraph 696 that

> [p]aragraph 247(2)(d) is sometimes referred to as a recharacterization rule … However, strictly speaking, paragraph 247(2)(d) does not authorize the Minister to recharacterize the transaction or series identified in the preamble. Rather, paragraph 247(2)(d) authorizes the Minister to identify an alternative transaction or series that in the same circumstances would be entered into by arm's length parties in place of the transaction or series and then to make an adjustment that reflects arm's length terms and conditions for that alternative transaction or series. Because the adjustment is based on the arm's length terms and conditions of an alternative transaction or series, the adjustment may alter the quantum or the nature of an amount.

Thereafter, in paragraph 714, the TCC analyses section 247(2)(b)(i) and states that:

> the subparagraph is asking whether the transaction or series under scrutiny would have been entered into by arm's length persons acting in a commercially rational manner. The focus of the test is the commercial rationality (or irrationality) of the transaction or series, taking into consideration all relevant circumstances … The determination of whether a transaction or a series is commercially rational requires an objective assessment of the transaction or series.

With respect to section 247(2)(b)(i), the key question analysed was whether it was commercially rational for the taxpayer to transfer its uranium trading business (business opportunity) to the Swiss subsidiary.[152] In response, the Court, in paragraph 719, highlighted its conclusion "that it is commercially rational for a person to give up a business opportunity and that the correct focus in such a situation is the compensation received for doing so. The issue of arm's length compensation is addressed by paragraphs 247(2)(a) and (c)." Moreover, the Court remarked, in paragraph 722, that "the behaviour of the parent corporation in establishing subsidiaries and placing business opportunities in those subsidiaries is not commercially irrational. I would go so far as to suggest that such behaviour is a core function of the parent of a multinational enterprise." Thus, the fact that the taxpayer transferred its business opportunity to a subsidiary cannot be considered to be commercially irrational, as independent parties would do the same if they were compensated adequately. Similar to the Swiss case (discussed in section 3.3.2.1.), in delivering its judgment, the TCC referred to the exceptional circumstances set out in the 1995 and 2010 versions of the OECD Guidelines.

The decision of the TCC was appealed by the tax administration before the Canadian Federal Court of Appeal (FCA).[153] As a starting point, the Court remarked in paragraph 43 that:

> subparagraph 247(2)(b)(i) of the Act does not refer to whether the particular taxpayer would not have entered into the particular transaction with the non-resident if that taxpayer had been dealing with the non-resident at arm's length or *what other options may have been available to that particular taxpayer. Rather, this subparagraph raises the issue of whether the transaction or series of transactions would have been entered into between persons dealing with each other at arm's length (an objective test based on hypothetical persons) – not whether the particular taxpayer would have entered into the transaction or series of transactions in issue with an arm's length party (a subjective test).* A test based on what a hypothetical person (or persons) would have done is not foreign to the law as the standard of care in a negligence case is a "hypothetical 'reasonable person'". [Emphasis added.]

148. ITA 1998; CRA, *2010 Update*, *supra* n. 110.
149. *See* Ministry of Finance Decree 2018-6865, at 5; *see also* NL: Ministry of Finance, Decree 2013-184 (14 Nov. 2013), secs. 2.1 and 12, available at http://www.oecd.org/ctp/transfer-pricing/netherlands-decree-arm%E2%80%99s-length-principle-2013.pdf (accessed 20 Oct. 2020).
150. *See* AU: Australian Taxation Office (ATO), Taxation Ruling 2014/6, *Income tax: Transfer pricing – the application of section 815-130 of the Income Tax Assessment Act 1997*, available at: https://www.ato.gov.au/law/view/document?docid=TXR/TR20146/NAT/ATO/00001 (accessed 20 Oct. 2020).
151. Paras. 739-743 *Cameco* (2018).
152. Id., at para. 717.
153. CA: FCA, 26 June 2020, *Cameco Corporation v. Her Majesty the Queen*, 2020 FCA 112.

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The emphasized material indicates that the key question analysed by both the TCC and FCA was whether the same transaction can be observed between independent parties, as opposed to whether the actual transaction (undertaken by the particular taxpayer) possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances. This is at odds with the guidance included in paragraph 1.123 of the OECD Guidelines (2017), which states "The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties". As a result, neither Court engaged in a detailed discussion of options realistically available.

The FCA, in paragraphs 66-68, also referred to the two exceptions contained in the 1995 and 2010 versions of the OECD Guidelines, but makes specific reference to the commercial irrationality exception. To reiterate, in order for this exception to apply, the OECD Guidelines (1995/2010) state that two cumulative criteria must be fulfilled. Keeping in mind the second criterion, the FCA stated that:

> in this case, there is no indication that the structure, as implemented, impeded the determination of an appropriate transfer price. There is nothing to indicate or suggest that the structure impeded either the Canada Revenue Agency's or the Tax Court Judge's ability to determine the appropriate transfer price.

As a result, the commercial rationality exception is not triggered and the income cannot be reallocated to the parent.

As the Courts did not enter into a detailed discussion of options realistically available, the judgment indicates that the power given to the tax administration under domestic law could be narrower than that provided in the OECD Guidelines. As a result, depending on the country, the scope of the national rule could be far more restrictive than the scope of article 9 (and the OECD Guidelines). Accordingly, depending on the country, courts may reject the application of structural adjustments (based on the commercial rationality exception) if the wording of the law (and its interpretation) does not provide that power.

On the other hand, if the wording of the national TP law (or its interpretation) provides for the application of this exception, then the question is whether article 9 can restrict its application. In the authors' opinion, firstly, given the fact that the discussion on this exception was added to the OECD Guidelines in 1995 (*see* section 3.2.), it should apply only to tax treaties concluded after the publication of those guidelines. This issue seems similar to the one discussed vis-à-vis the guiding principle introduced in the Commentary on Article 1 in 2003. One of the authors of this contribution has already argued that the guiding principle should apply only to treaties concluded after 2003.[154] Following this line of thinking, the commercial rationality test should also apply only to treaties concluded after its introduction.

Another question is whether the 2017 update is clarificatory in nature, given the fact that the exception has been reshaped in the OECD Guidelines (2017) as compared to its previous versions – and, in particular, with respect to the second cumulative condition (1995 and 2010).

To reiterate, in order for the controlled transaction to be commercially irrational, it should:

- differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances,
- thereby preventing determination of a price that would be acceptable to both of the parties taking into account
  - their respective perspectives; and
  - the options realistically available to each of them at the time of entering into the transaction.

In the present authors' view, it seems that, as the practical impediment requirement has been reshaped, it could be argued that the new wording should apply to treaties concluded post 2017. That said, it must be acknowledged that, while the answer to this question is not an easy one, the updated Dutch Transfer Pricing Decree 2018-6865 contains an interesting example in section 5.1 to illustrate the application of the new guidance in the context of intangibles.[155] The example deals with a situation in which an intangible is sold by one group member (a Dutch seller) to another group member (the buyer), and the latter does not have adequate personnel (functionality) to control key risks with respect to the intangibles. In this situation, the guidance states that:

> based on the arm's length principle, associated parties are expected to strive for profit maximization. Independent parties will normally enter into a transaction relating to a tangible/intangible fixed asset only if they can both expect an increase in their own profit. This expectation is only a realistic possibility for the seller and buyer if it involves an increase in the joint profits of the buyer and seller compared to the joint profits of both without the transaction. *The expected profit increase can only occur if the buyer adds value in some way. This is only possible if the buyer possesses the relevant functionality and is therefore able to control the relevant risks. If there is no expected increase in the joint profit, the bid price of a potential buyer will be lower than the price asked by a potential seller. In that case, transfer of the asset is not commercially rational and will not take place, partly because the transfer also entails transaction costs. Such a transaction between associated parties does not satisfy the arm's length principle.* [Emphasis added.]

154. For a detailed analysis, *see* Chand, *supra* n. 40, at 186-202.
155. *See* Ministry of Finance Decree 2018-6865, at 5 (2018).

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Additionally, the concept of options realistically available is explored, and it is stated that:

> [i]n addition, in the arm's length assessment, *attention must also be paid from the perspective of both the seller and the buyer to whether the seller and/or the buyer have other realistically available options that are more attractive to them. In the situation described above, it is a realistically available and more attractive option for both the seller and the buyer not to enter into the transaction. The total operating profit that the parties would achieve jointly is not higher than if the transfer had not taken place. Because the transfer would be accompanied by extra costs (for example, the drafting of contracts), the joint operational result is expected to be even lower than if no transfer had taken place.* [Emphasis added.]

In this situation, the tax administration states that, "[o]n the basis of the arm's length principle, the disadvantage of using conditions that deviate from conditions that would have been agreed by independent parties, should be eliminated from the taxable profit of the Dutch seller. This disadvantage is the difference in profit compared with a situation where the transfer did not take place." Arguably, this example could also be analysed under the concept of accurately delineating the transaction, as explained in examples 2 and 3 in the annex to chapter VI of the OECD Guidelines (2017).[156] Accordingly, the boundary between accurately delineating the transaction and applying the commercial rationality exception seems blurred under the Dutch guidance.

This blurred boundary in also reflected in the recent guidance issued by the Australian Taxation Office (ATO). To begin with, it should be noted that the ATO has updated the TP legislative references to OECD guidance and has confirmed that Australia's TP rules should be interpreted consistently with the OECD Guidelines (2017), which reflect the changes made as a result of the BEPS Actions 8-10 Final Reports.[157] With respect to intangibles, the ATO has recently issued Taxpayer Alert 2020/1 on "non-arm's length arrangements and schemes connected with the DEMPE of intangible assets".[158] In the three different fact patterns presented, the ATO indicated that profit reallocations can be made from foreign entities to Australian entities under the Australian TP rules if the latter perform key DEMPE activities. It seems that the ATO would apply the commercial rationality exception, as it is remarked that "[w]here AusCo's entry into the arrangement exhibits a lack of commercial rationale or is not consistent with its best economic interests having regard to the commercial options realistically available, the exceptions in the transfer pricing provisions … may apply". At the same time, based on a reading of the examples, the arrangements or part of the arrangements could be analysed under the economic substance exception (or under the broad scope of accurately delineating the transaction).

In conclusion, an analysis of the above material indicates that classifying an arrangement as commercially irrational is a highly complex area, especially with respect to intangibles.[159] First, it would be essential to determine all the facts and circumstances of a case in combination with evidence that such arrangements would not have existed between independent parties in comparable circumstances. Second, options realistically available need to be considered from the perspective of both parties, in conjunction with clearly more attractive options (including the option of not entering into a transaction).[160] Due to its complexity, it is not a surprise that the OECD Guidelines (2017) emphasize that non-recognition should apply only in exceptional circumstances, and that every effort should be made to determine transfer prices without recourse to non-recognition.[161]

However, the authors would like to state that, even after making huge efforts, it is not always easy to determine transfer prices for intangibles, and in particular for HTVIs.[162] The decision of the US Court of Appeals for the Ninth Circuit in the case of *Amazon* (2019)[163] makes this very clear. In that case, Amazon US entered into a cost-sharing arrangement (similar to a CCA) with Amazon Luxembourg for its pre-existing intangibles. The latter entity made a buy-in payment of USD 255 million to gain access to the IP, which it could then exploit for commercial purposes. However, the US tax administration argued that an arm's length transfer price would amount to USD 3.6 billion (resulting in higher taxable income in the United States). In the end, the Court of Appeals sided with the decision of the US Tax Court, and held that the buy-in should be valued at USD 779 million. While in this case the US tax administration challenged the pricing of the

156. On the flip side, the example indicates that if the sale was at arm's length and the buyer has the necessary functional profile to control risks then the transaction should be respected. *See OECD Guidelines* (2017), *supra* n. 2, at annex to chapter VI, examples 4 and 5.
157. *See* ATO, *Transfer Pricing Legislation Update* (last updated 4 Aug. 2020), available at https://www.ato.gov.au/General/New-legislation/In-detail/Other-topics/International/Transfer-pricing-legislation-update/ (accessed 20 Oct. 2020).
158. *See* ATO, Taxpayer Alert (TA) 2020/1, available at https://www.ato.gov.au/law/view/document?DocID=TPA/TA20201/NAT/ATO/00001&PiT=99991231235958 (accessed 20 Oct. 2020); *see also* A. Seve, P. Austin & R. Wright, *Australian Taxation Office Audit Focus on Arrangements Involving Intangibles*, 27 Intl. Transfer Pricing J. 3 (2020), Journal Articles & Papers IBFD.
159. *OECD Guidelines* (2017), *supra*. n. 2, at para. 6.114.
160. Id., at paras. 6.113-6.114. For a discussion on documenting the options realistically available, *see also* id., at ch. VI, example 29.
161. Id., at para. 1.121.
162. OECD/G20, *Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles – Inclusive Framework on BEPS: Action 8* 11-33 (OECD 2018), Primary Sources IBFD.
163. US: CAFC Ninth Circuit, 16 Aug. 2019, Case 17-72922, *Amazon.com and Subsidiaries v. Commissioner of Internal Revenue*, Case Law IBFD.

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transaction, it could well be possible that in the future such structures are analysed under the reconstruction/non-recognition provisions. This would be the case when the transfer involves valuation uncertainty (it was not easy to determine the value of the transferred intangibles) and/or a static pricing component (lump sum payment similar to a buy-in). In these circumstances, the tax administrations could use ex post outcomes to determine the commercial rationality of arrangements as well as the options realistically available to the parties. Accordingly, they may argue that it is commercially irrational for the taxpayer (parent) to enter into a CCA with its subsidiary and as result not recognize IP transfers or apply price adjustment clauses.[164]

3.3.3. The broader debate: Application of national anti-abuse rules

Domestic anti-abuse rules could also be used to challenge intangible ownership structures and make income reallocations.[165] For instance, states could use GAARs. The effect of applying these general rules could overlap with the two exceptions discussed in section 3.3.2. Indeed, such rules could recharacterize or disregard transactions which do not have economic substance or which are commercially irrational. Due to the overlap, some authors have argued that the disregarding procedure contained in paragraph 1.122 of the OECD Guidelines should apply only in the context of GAARs and not within the context of TP rules.[166] Of course, tax administrations will follow this path when the local TP law does not contain the commercial rationality exception.

In order to obtain a better understanding of the discussion, consider the following situation. Co R from Country R (the parent, in a high-tax location) develops an intangible which is ready for exploitation. Co R sets up a new subsidiary, viz. Co T in Country T (a low-tax location). The entity is funded with cash and, in return, issues equity shares to Co R. Co R sells its intangibles to Co T in return for an arm's length amount. Co T uses the cash to pay off the amount. Then Co T licenses the intangibles to related companies and receives royalty income. The facts based on actual conduct indicate that Co T has no personnel who carried out the control function associated with the acquisition of the intangible. At the same time, it has no personnel who control key decisions regarding the licensing activities. A detailed factual analysis indicates that key decisions are made by Co R.

In this scenario, the tax administration of Country R could apply the economic substance exception (to accurately delineate the transaction) or commercial reality exception (similar to the Dutch or Australian approach) pursuant to national TP rules and reallocate substantial income to Co R. At the same time, the tax administration of Country R could challenge the structure under a national statutory GAAR. Moreover, if Country R has a controlled foreign company (CFC) rule, it could well be possible that the income of Co T could be reallocated to Co R. The question is whether article 9 or other treaty provisions restrict this reallocation made under the GAAR or CFC rule. This issue has been raised and analysed by Chand & Elliffe (2020)[167] and Kofler & Verlinden (2020);[168] however, the interaction between GAARs, TP rules and CFC rules, it is beyond the scope of this contribution.

4. Conceptual Issue

4.1. The issue

As described earlier in this article, if an entity within an MNE group performs key DEMPE functions, exercises control over the risks and has financial capacity in connection with the key DEMPE functions. then the majority of the residual returns/profits in relation to the intangibles should be allocated to that entity. Examples 14 and 15 in the annex to chapter VI of the OECD Guidelines (2017) illustrate this point. The issue analysed in this section will be whether the entity providing the funds in relation to the development of the intangible, assuming it is different from the entity performing key DEMPE functions, can or should also be entitled to residual/substantial profits derived from the intangible. A related question is how to determine the remuneration of the entity financing the development of the intangible.

4.2. International guidance on the role of the funder

4.2.1. Funder not controlling financial risks: risk-free return

In the event that the funder of an intangible does not perform any key DEMPE functions, according to the OECD Guidelines (2017), the level of the remuneration to be derived by the financing entity depends on the ability of the funder to exercise control over the financial risk associated with the provision of funding.

164. A. Ting, *Intangibles and Transfer Pricing Reconstruction Rules: A Case Study of Amazon*, British Tax Review 3, 302-334 (2020); *see also* J.G. Ballentine, *Under Arm's-Length Buy-Ins, Taxpayers Will Not Cost-Share R&D*, Tax Notes Intl. (8 Oct. 2020), Journal Articles & Papers Tax Analysts.
165. For an example, *see* the approach discussed in ATO, TA 2020/1.
166. L.D. Roja & P.N. Nina, *The Use of Paragraphs 1.119 to 1.128 of the 2017 OECD Transfer Pricing Guidelines for the Application of Transfer Pricing Rules*, 48 Intertax 6/7, 623 (2020).
167. *See* V. Chand & C. Elliffe, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties in the Post-BEPS and Digitalized World*, 74 Bull. Intl. Taxn. 4/5 (2020), Journal Articles & Papers IBFD.
168. *See* G.W. Kofler & I. Verlinden, *Unlimited Adjustments: Some Reflections on Transfer Pricing, General Anti-Avoidance and Controlled Foreign Company Rules, and the "Saving Clause"*, 74 Bull. Intl. Taxn. 4/5 (2020), Journal Articles & Papers IBFD.

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Exercising control over a specific financial risk requires the capability to make the relevant decisions related to the provision of the funding, together with the actual performance of these decision-making functions.[169] The party exercising control over the financial risk must perform the activities in relation to day-to-day risk mitigation, which requires the capability to make the relevant decisions related to the risk-bearing opportunity.[170] Depending on the situation, funding decisions may depend on the assessment of how the risks related to the development project may impact the expected return on funding provided or additional funding required (for example, decisions may have to be made on whether to take the project to the next stage).[171]Therefore, it is crucial that the funder has the capability to assess the progress of the development of the intangible and the need for a continued provision of funding.[172] When the risk-bearing and mitigation activities are outsourced, the funder must have the capacity to control the tasks that have been outsourced and perform any preparatory work necessary to facilitate the decision-making process.[173]

Where the provider of the capital does not exercise control over the financial risks, that entity should not be entitled to more than a risk-free return.[174] This is the case when the funding party does not have the capability to make decisions to take on or decline the financing opportunity, or the capability to make decisions on whether and how to respond to the risks associated with the financing opportunity.[175] In this situation, a risk-free return represents an appropriate measure of the profits that the funder is entitled to retain.[176]

An example in which the funder of the intangibles would be entitled to only a risk-free return is discussed in example 16 in the annex to chapter VI of the OECD Guidelines.[177] In this example, Shuyona sells all its existing intangibles (patents and other technology-related intangibles) to a new subsidiary, Company T, which contractually agrees to bear the financial risk associated with possible failure of future R&D projects. Company T, which is also a manufacturing entity, has no technical or financial personnel capable of conducting or supervising the research activities. The actual facts (or real deal) indicate that Shuyona continues to supervise and control the R&D activities pursuant to the sale of the intangibles. Moreover, Company T does not perform any key DEMPE functions and does not control risks in relation to any of those functions. The result of a deep functional analysis is that Company T is only providing financing corresponding to the costs of the acquired intangibles and related development. In addition, although Company T contractually assumes the financial risk and has the financial capacity to assume that risk, it does not exercise control over that risk. Thus, Company T is entitled to no more than a risk-free return for its funding activities. The example is also similar to the example contained in the Dutch Transfer Pricing Decree 2018-6865 (discussed in section 3.3.2.2.). In light of that, it could well be possible that tax administrations could recharacterize the transfer of the intangible.

Guidance on calculating such returns was recently provided in the OECD's finalized report on Transfer Pricing Aspects of Financial Transactions (BEPS Actions 8-10).[178] The guidance states that a risk-free rate of return is the hypothetical return that would be expected on an investment with no risk of loss. As, in reality, there is no investment with zero risk, certain government-issued securities can be used as reliable proxies of risk-free returns, as these securities are generally considered by market practitioners as carrying no significant default risk.[179] It is also stated that, depending on the facts, other proxies could be used, such as "interbank rates, interest rate swap rates or repurchase agreements of highly rated government issued securities".[180]

4.2.2. *Funder controlling financial risks: risk-adjusted return*

Unlike the situation discussed in section 4.2.1., a member of an MNE group that funds some or all of the DEMPE functions, while all the relevant functions are performed by other member(s) of the group, should generally be entitled to only a risk-adjusted return on its funding, provided that it exercises control over the financial risks associated with the provision of funding.

In determining the risk-adjusted rate, it is important to identify and differentiate the financial risk that is assumed by the funder in carrying on its financing activity, and the operational risk that is assumed by the funded party and is connected to the use of the funds,

169. *OECD Guidelines* (2017), *supra* n. 2, at para. 6.63.
170. Id.
171. Id.
172. Id.
173. Id.
174. *Actions 8-10 Final Reports*, *supra* n. 3, at 64.
175. *OECD Guidelines* (2017), *supra* n. 2, at para. 1.103.
176. Collier & Andrus, *supra* n. 35, at paras. 7.25-7.30.
177. *OECD Guidelines* (2017), *supra* n. 2, at annex to chapter VI, example 16.
178. OECD/G20, *Transfer Pricing Guidance on Financial Transactions – Inclusive Framework on BEPS: Actions 4, 8-10* (OECD 2020), Primary Sources IBFD [hereinafter *OECD Guidance on Financial Transactions*].
179. Id., at para. 1.110. *See also* S. Reif & V. Chand, *The Fundamental Approach for Allocation of Risks and Returns for Financing Entities,* Kluwer International Tax Blog (12 July 2018), available at http://kluwertaxblog.com/2018/07/12/fundamental-approach-allocation-risks-returns-financing-entities/?doing_wp_cron=1598000880.1861310005187988281250 (accessed 20 Oct. 2020).
180. *OECD Guidance on Financial Transactions* (2020), *supra* n. 178, at para. 1.115.

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e.g. for developing an intangible asset.[181] If the funder of an intangible asset does not participate in its development and the DEMPE functions are performed by other affiliated entities, it will be remunerated only for the financial risk (provided that it has the capability to control this risk).

The OECD Guidelines (2017) provide a few examples in which the funder of the intangibles is not involved in the DEMPE functions and, therefore, would be entitled only to a risk adjusted return. In example 17,[182] while the transaction is delineated as the provision of financing by Company S, there is no discussion on whether this return will be a risk-free or a risk-adjusted return. It is stated only that this depends on the level of control over the financing risks exercised by Company S (which is not specified in the example). A more concrete example pertains to example 6,[183] in which a multinational group comprised of Company A and Company B decides to develop an intangible that is "anticipated to be highly profitable based on Company B's existing intangibles". The two companies conclude a development agreement, under which Company B will perform all the DEMPE functions in relation to the intangible and Company A will provide all the funding associated with the development of the intangible and will become the legal owner of the intangible. In addition, Company B will license the intangible from Company A and make contingent payments to Company A for the right to use the intangible. As the intangible is expected to become commercially exploitable within five years, Company A provides funding of USD 100 million per year for the first five years (a total of USD 500 million). Thereafter, the intangible is exploited and it generates a return of USD 550 million a year.

Based on the actual conduct, the outcome of the deep functional analysis is that, although Company A is the legal owner of the intangible, its sole contribution to the arrangement is the provision of funding for the development of the intangible. Given that Company A has the financial capacity to assume the financial risk, and exercises control over that risk, the remuneration of Company A should be a risk-adjusted return. In this example, it is determined that Company A will be entitled to a return of 11% on its funding commitment, that is, USD 110 million a year (for years 6-15). The balance (USD 440 million) will be allocated to Company B. It is not clear whether the funding by Company A was in the form of a debt or equity investment or through a CCA. Further, there is no discussion on whether these returns are ex ante or ex post returns. Moreover, the example does not discuss how the 11% risk-adjusted rate of return was determined. Overall, by applying the key DEMPE functions approach in this example, the provider of labour and not the funder of capital is considered the "residual claimant" of business profits, because the party funding the activity has a "fixed remuneration" and "what remains" of revenues and cash flows derived from the use of the intangible is attributed to the entity performing intangible-related activities.

The OECD's finalized report on Transfer Pricing Aspects of Financial Transactions (BEPS Actions 8-10) provides further insight into this issue. The guidance deals with an example in which Company F provides funding (which it controls) in the form of a loan to Company D, and the latter develops the intangible. In this example, it is stated that Company F is entitled to only risk-adjusted returns. Interestingly, it is also stated that, in the event that the ex post results derived from the exploitation of the developed intangible were higher (or lower) than the results calculated on an ex ante basis, the funder would not be entitled to derive the difference of return as it does not bear any operational risk.[184]

The risk-adjusted rate of return can be determined using different approaches. For example, depending on the exact facts, it could be determined based on (i) the return of a realistic alternative investment with comparable economic characteristics;[185] (ii) adding a risk premium to a risk-free return;[186] or (iii) the cost of funds approach.[187]

4.3. The authors' perspective

4.3.1. Development of intangibles that represent high-risk investments

When the funder invests funds in high-risk investments, then it should be entitled to higher returns (which could be positive or negative).[188] An example of a high-risk investment is an early-phase R&D project to develop new intangibles or blue-sky research.[189] Indeed, in market economies, capital invested in and bearing the risk of the development of intangibles or any other type of asset – before knowing whether the investment will be successful or not – is probably the most important and pure source of a company's residual profits (or losses).[190]

In these situations, when the entity funding the development of an intangible does not carry out R&D activities, then the funding entity should not be expected to lose its right to receive the residual profit. For example, in the venture capital sector, a common business

181. Id., at para. 1.118.
182. *OECD Guidelines* (2017), *supra* n. 2, ch. VI, example 17, at 583.
183. Id., at ch. VI, example 6, at 568.
184. *OECD Guidance on Financial Transactions* (2020), *supra* n. 178, at para. 1.119.
185. Id., at para. 1.123.
186. Id., at para. 1.124.
187. Id., at para. 1.126.
188. *OECD Guidelines* (2017), *supra* n. 2, at paras. 6.60 and 6.63.
189. Torvik, *supra* n. 126, at 647-649.
190. Musselli & Musselli, *supra* n. 8, at 331.

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model is to invest in start-up companies developing new valuable business models and intangibles. In such a scenario, investors are not involved in the actual day-to-day business and do not perform any material economic functions in relation to their investment (doing research). This said, funders assess the progress of the development on a regular basis and decide whether or not to contribute further funding. If the investment is successful, a substantial portion of the return is attributed to the investors.[191] Torkiv (2018) states that "[v]enture capitalists in 2011 generally required a return … on their investments of 30-70%".[192] Thus, an investment in developing new high-risk intangible assets by providing funds to an associated developer entity should entitle the funder to obtain part of the residual profits from the investment. The "return of a realistic alternative investment with comparable economic characteristics" would be the returns earned by other venture capitalists (or similar investors).

As a result, risk-adjusted returns in these cases could represent returns on residual profit. In this scenario, it could well be possible that the funder is entitled to a share of the difference between ex ante and ex post results. Moreover, in these situations the transactional profit split method could apply to split the profits as the operational R&D risks (borne by the entity performing key DEMPE functions) and financial risk (borne by the funder) are interrelated and intertwined to a great extent. Indeed, one of the situations in which the profit split method applies is when each party separately assumes interrelated economically significant risks.[193] In these circumstances, if tax administrations were to allocate the residual returns from an intangible only to the entity/entities performing the key DEMPE functions and not to the entities funding the intangible, this would in principle result in a violation of the ALP.[194]

The conclusion can also be supported by the work of the OECD in applying the AOA to PEs of enterprises carrying out global trading of financial instruments. In particular, the OECD's 2010 Report on the Attribution of Profits to Permanent Establishments analysed a situation in which one associated enterprise provided capital and the other associated enterprise carried out the high-risk global trading functions. Paragraph 157 of part III of the report states that:

> [w]here the activity undertaken is high risk, the potential reward will be higher, and in situations where the activity is more complex, there may be fewer transactional comparables. In such circumstances, the capital provider and trader may enter a profit split arrangement and, at the extreme, a profit split methodology may be an appropriate method of rewarding the parties.[195]

In this regard, consideration is given to the hedge fund model, in which the investor (capital provider) is allocated substantial returns as a result of a high-risk investment.[196]

4.3.2. *Development of intangibles that do not represent high-risk investments*

On the other hand, if the funder invests in projects which are not high-risk investments, then its return should be lower. An example of such investment is funding second-generation R&D projects,[197] in which the investment risk in moderate or low.[198] Several examples in the OECD Guidelines (2017) discuss these types of investments, in which two related parties come together to develop an intangible, with one party providing the funding and the other party contributing existing intangibles. For instance, in example 6 (discussed in section 4.2.2.), Company A and Company B come together to develop an intangible "which is anticipated to be highly profitable based on Company B's existing intangibles, its track record and its experienced research and development staff". In particular, Company B "will perform and control all activities related to the development, enhancement, maintenance, protection and exploitation of the intangible", whereas Company A will provide the funding, which it controls. In this example, the funder is entitled to a risk-adjusted return of 11% (per year).[199] Based on a reading of this example, it seems that the OECD Guidelines (2017) argue that Company A should be treated as the tested party in any TP analysis. The present authors take a different view. Arguably, in these situations, depending on the exact risk profile, the profit split method could be deployed, as the developmental and financial risks seem to be interrelated. As with the situation discussed in section 4.3.1., this would be the case when the funder assesses the progress of the development of the intangible on an ongoing basis in order to decide whether or not to provide continued funding. A similar illustration is provided in example 4 of the annex to chapter VIII (in a CCA context).

Additionally, there could be situations in which a funder is funding only low-risk projects or is funding

191. Id.
192. Torvik, *supra* n. 126, at 650-652.
193. OECD/G20, *Revised Guidance on the Application of the Transactional Profit Split Method – Inclusive Framework on BEPS: Action 10* (OECD 2018), at paras. 2.139-2.142.
194. For a similar discussion, *see* A. Musselli and A. Musselli, *supra* n. 8, at 339; Hoor, *supra* n. 1, at 168.
195. For a detailed analysis *see OECD 2010 Report*, *supra* n. 129, at para. 157. *See also* Collier & Andrus, *supra* n. 35, at paras. 5.86-5.92.
196. For a detailed analysis *see OECD 2010 Report*, *supra* n. 129, at paras. 160-164.
197. Torvik, *supra* n. 126, at 652.
198. *OECD Guidelines* (2017), *supra* n. 2, at paras. 6.60 and 6.63.
199. A similar fact pattern is discussed in arrangement 1 of ATO, TA 2020/1, at 652. In that example, the ATO argues that AusCo (the entity carrying out the key DEMPE functions) should be entitled to additional profits, and not the entity providing the funding.

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investment without assessing ongoing developments on a regular basis. Depending on the accurate delineation of the transaction, it could well be possible that the funder should only be entitled to a predetermined return, as discussed in paragraph 1.119 of the OECD's finalized report on Transfer Pricing Aspects of Financial Transactions (BEPS Actions 8-10).[200] It those situations, the adjusted return could be determined by adding a risk premium to a risk-free return or by using the cost of funds approach.

The above conclusion can once again be supported by the OECD's work on applying the AOA to PEs of enterprises carrying out global trading of financial instruments. Once again, reference may be made to the situation in which one associated enterprise provides capital and the other associated enterprise carries out low-risk trading functions. Paragraph 157 of part III of the OECD 2010 Report on the Attribution of Profits to Permanent Establishments states that, "where a low risk asset is created, the credit risk management activities may be expectedly less significant such that an arm's length arrangement might be that the trader would be rewarded on a commission basis (for which a suitable CUP should be available) and the enterprise possessing the capital would receive the balance of the return on the asset (that residual return may of course be very little as low risk assets require little if any capital, and are funded largely by interest-bearing debt)".[201] In this connection, it is stated that the hedge fund model cannot be considered to determine comparable returns. It is also subsequently stated in paragraph 164 that "[e]stimated future profits can be more readily ascertained for lower expected risk of particular kinds. Accordingly, although a capital provider bears the risk of loss as counterparty to transactions, a low expectation of such risk may warrant a CUP for measuring the appropriate return to capital by reference to fixed rates lenders obtain for similarly low risks".[202]

5. Practical Issues

5.1. The issue(s)

5.1.1. Difficulties in application by MNEs

In addition to the above issues, the effective identification and analysis of the DEMPE functions is quite a challenging exercise in practice. In MNEs, it is often the case that several departments control risks that are linked to DEMPE.[203] Some departments may be focused predominantly on R&D (patent, know-how), while others may deal with marketing intangibles (brands, tradenames), and the value of the latter is often embedded in the value of manufacturing intangibles.[204]As a consequence, within MNEs, DEMPE functions may be controlled by several different people at various levels (e.g. board level or management level with the MNE).[205] Therefore, the decision-making process is spread across the whole hierarchy of a given organization or a unit.[206]This makes identifying the contributors to the DEMPE functions and the analysis of the level of their contribution very complex in practice. The complexity is also created by the difficulty in deciding the level of granularity that a DEMPE analysis should adopt.[207] In this respect, a common view among practitioners is that the focus of the DEMPE analysis should be on the key value drivers, i.e. the firm specific assets that can affect the mid/long-term performance of a company[208] and allow the realization of profits in excess of the market return.[209]As people play a crucial role in the performance of the DEMPE functions, one approach to analysing DEMPE would be the classification of the contributions of different people within the MNE into operational, tactical and strategic components,[210]with the objective of determining the "key people" performing "key functions".[211] In practice, this information may not be very easily obtained for confidentiality reasons,[212] which may not allow a complete disclosure of the decision powers of the "key people".

Another obstacle to collecting the information relevant for assessing the contribution to DEMPE functions would be insufficient internal communication and underestimation of the tax implications relating to intangibles by executives, IP creators and R&D specialists (i.e. the "key people"). The analysis and documentation of IP value creation and life cycle requires more than annual email exchange and short emails between the above-mentioned key people and the specialists working in the finance and tax functions of an MNE.[213] Instead, MNEs should arrange for a continuous and transparent exchange of information on the value creation and management of intangibles, while mitigating the risk that crucial information is divulged by people leaving the company.[214] Other important practical issues relating to the assessment

200. *OECD Guidance on Financial Transactions* (2020), *supra* n. 178, at para. 1.124.
201. For a detailed analysis *see OECD 2010 Report*, *supra* n. 129, at para. 157. *See also* Collier & Andrus, *supra* n. 35, at paras. 5.86-5.92.
202. For a detailed analysis, *see OECD 2010 Report*, *supra* n. 129, at paras. 160-164.
203. I. Verlinden, S. De Baets & V. Parmessar, *Grappling with DEMPEs in the Trenches: Trying to Give It the Meaning It Deserves,* 47 Intertax 12, 1054 (2019).
204. S. Næss-Schmidt et al., *Future Taxation of Company Profits: What to Do with Intangibles?* (Copenhagen Economics 2019).
205. Verlinden, De Baets & Parmessar, *supra* n. 203.
206. P. Paumier, *TP Aspects of Intangibles: How Deep Should DEMPE Be?*, Intl. Tax Rev. (17 Feb. 2020), available at https://www.internationaltaxreview.com/article/b1kblpstc76wl3/tp-aspects-of-intangibles-how-deep-should-dempe-be (accessed 20 Oct. 2020).
207. Id.
208. Id.
209. Verlinden, De Baets & Parmessar, *supra* n. 203, at 1049.
210. Paumier, *supra* n. 206.
211. Verlinden, De Baets & Parmessar, *supra* n. 203, at 1049.
212. Paumier, *supra* n. 206.
213. Verlinden, De Baets & Parmessar, *supra* n. 203, at 1049.
214. Id., at 1055.

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of the contributions to the DEMPE functions are the increasing digitalization of the R&D function, resulting in contributors based in different locations, and the difficulty of analysing the contribution provided by a team rather than an isolated contributor, especially in cases in which the team is composed of people working in different departments, companies and/or jurisdictions.[215]

Thus, it may be extremely difficult to identify and remunerate DEMPE functions in the presence of a high number of intangibles and of several people/departments contributing to the various DEMPE functions. In order to determine the effective involvement of the key contributors, it might be necessary to go beyond the "traditional" TP frameworks and embrace corporate strategy models, enterprise risk management frameworks and corporate governance tools. In this respect, useful models and tools would be value chain analysis (VCA) and the RACI/RASCI model, described in sections 5.2.1. and 5.2.2. respectively.

5.1.2. Risk of subjective application by tax authorities

As rightly stated by Hoor (2018), understanding the relative importance of various DEMPE functions is a highly subjective exercise and different tax authorities may arrive at different conclusions.[216] This outcome represents a major problem for businesses and may result in legal uncertainty.Transactions could be challenged several years after they took place.[217] Musselli & Musselli (2017) reiterate this point and remark that the key DEMPE functions could give rise to never-ending discussions between taxpayer and tax administrations.[218] Heggmair (2017) also supports this view, and raises the issue that local tax authorities may feel encouraged to reallocate the risks and, accordingly, the profit potential of intangible assets based on little more than their subjective evaluation of local people's activities and functions performed in the value chain.[219] In addition, a greater risk or concern is that the tax authorities could apply the new approach based on DEMPE as a kind of a "freedom of choice" situation, meaning that, in the case of loss-making transactions, the losses would be assessed in accordance with the contractual terms; whereas, in the case of profits, the contractual terms would be rejected and profits allocated on the basis of subjective evaluations of DEMPE functions. On this point, the recent Apple case (discussed in section 3.3.2.1.2.) clearly shows the tension between the EC and the taxpayer (as well as the Irish government) with respect to the value to be attributed to the functions performed by personnel working in the branches of ASI[220] and AOE.[221]

5.1.3. Outcome: Risk of double taxation

Regarding the risk of economic double taxation, Hoor (2018) remarks that the main concern is whether the other state will agree to perform a corresponding adjustment for the elimination of double taxation if a TP primary adjustment relates to the DEMPE functions concept.[222]This problem becomes even more evident when considering controlled transactions involving entities resident in several jurisdictions.[223] Therefore, if efficient dispute resolution mechanisms to provide relief from double taxation are not enforced (as is the case at the moment), companies will probably have to suffer double taxation.[224] MNEs are therefore expected to face tough and time-consuming discussions with several tax authorities about their value chains and the relative contribution of people functions and activities to these value chains, without having the legal security of a binding arbitration solution to resolve the double taxation (in the majority of situations).[225]

Another important element to consider is that tax authorities are more and more required to have an in-depth understanding of business models as well as the ability to perform economic analysis. In practice, few countries will have a sufficient number of TP specialists (economists, evaluators and so on) available at the direct tax administration.[226] In this respect, the potential future scenario would be that the outcome of the discussions and disputes in relation to transactions involving intangibles would be even more based on the economic and bargaining power of countries and companies. According to Musselli & Musselli (2017), countries with significant economic and political power, which are likely to have tax inspectors and economists prepared to engage in discussions on TP with MNEs, are likely to claim most of the profits resulting from an international business.[227] Similarly, large MNEs that may have a great influence on government policies are less likely to bear the consequences of the uncertainty and to suffer double taxation compared to small and medium-sized enterprises that may not have the same bargaining power.[228]

All the above is expected to generate high uncertainty in the fiscal and economic international environment, which is likely to impact the predictability of busi-

215. Paumier, *supra* n. 206.
216. Hoor, *supra* n. 1.
217. Id., at p.169.
218. Musselli & Musselli, *supra* n. 8, at 335.
219. M. Heggmair, *The New Interpretation of the Arm's Length Principle: A Post-BEPS Evaluation*, 24 Intl. Transfer Pricing J. 4, 265 (2017), Journal Articles & Papers IBFD.
220. Paras. 255-284 *Ireland v. European Commission*.
221. Paras. 285-295 *Ireland v. European Commission*.
222. Hoor, *supra* n. 1, at 169.
223. Id.
224. Musselli & Musselli, *supra* n. 8, at 341; *see also* sec. 5.2.4.
225. Heggmair, *supra* n. 219, at 266.
226. Id., at 265.
227. Musselli & Musselli, *supra* n. 8, at 340-341.
228. C.(X). Peng & M. Lagarden, *DEMPE Functions and the RACI Concept – More Clarity or Confusion Ahead?*, 26 Intl. Transfer Pricing J. 1, 5 (2019), Journal Articles & Papers IBFD.

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ness decisions and potentially affect global economic growth. Thus, the application of the new elements introduced in the ALP based on DEMPE functions triggers the concern that local tax authorities may feel encouraged to reallocate risks. This is likely to cause legal uncertainty, a massive administrative burden, cross-border disputes and an unforeseeable risk of double taxation for MNEs.

5.2. The authors' perspective

5.2.1. Value chain analysis

A value chain analysis (VCA) can be a useful tool in the analysis of the DEMPE functions, as it may help determine the key value drivers, i.e. the factors that contribute to creating a competitive advantage and allowing an MNE to generate profits above market standards. A VCA aims at identifying the relevant valuable activities and distinguishing the primary activities from the support activities. Primary activities are those more related to the creation and sale of product and services, including intangible assets,[229] while support activities are activities that support all the primary activities such as HR, finance, IT, etc. In addition, the VCA, by mapping the company's various activities and attributing a certain weight to each of them, can help in the identification of intangible assets and their contributors.[230] Factors that contribute to value creation can be represented by unique, identified and protected intangibles, but may also include risks borne, market characteristics, location, business strategies, MNE group synergies, etc.[231] In this respect, a VCA can reveal the existence of a number of unique intangibles that may or may not be the outcome of the R&D function of the group (such as, in the latter case, marketing intangibles).[232]

As highlighted earlier in this article, the OECD Guidelines (2017) require companies and tax authorities to have a deep understanding of the industry in which the MNE operates, as well as of the relevant factors that influence performance. In this respect, VCA can be considered an important support tool, as it allows an understanding of the specific factors that constitute differentiators and sources of advantage for an MNE compared to its competitors within the same industry. VCA may be a useful instrument for distinguishing routine from non-routine activities,[233] and, therefore, for ultimately identifying those activities that deserve a portion of the residual profit and those that require only a compensation based on a cost-plus, resale price or transactional net margin methods.[234]

Although the VCA should not be directly used to determine the arm's length price or compensation of a transaction, it can nevertheless be considered an important support tool in preparing a complete functional analysis and an effective option for validating the outcome of a TP method or policy applied by a company.[235]

5.2.2. Use of the RA(S)CI model in the TP analysis

The performance of DEMPE functions and the assumption of the risks related to those functions are the two main areas to be considered in allocating intangible-related profit within MNEs.[236] Hence, an assessment should be performed of the contribution of each entity in terms of the functionality and the resources effectively used to carry out the DEMPE functions and assume the related risks. For this purpose, a well-established business tool is the RACI model. This model is usually used by MNEs for identifying and classifying the role of each entity/establishment as a responsible, accountable, consulted and informed (RACI) business unit.[237] The RACI model can be extended to a RASCI variation, where the S in middle of the abbreviation stands for a "support" function.[238]

According to Peng & Lagarden (2019), the RA(S)CI model can help in the application of the DEMPE method by mapping through a table or matrix the roles and responsibilities of affiliated entities involved in the DEMPE of intangibles.[239] In this way, there would be a clear overview of the contribution of each entity to each DEMPE function. For example, in relation to the development activities, the table or matrix would show which entity (entities) is (are) responsible, which entity (entities) is (are) accountable, which entity (entities) is (are) informed, and so on. Therefore, the RA(S)CI model can be considered a helpful instrument for performing a more detailed functional analysis at a qualitative level, and this can present an enhanced view of which entity is doing what, as well as the level of involvement of each entity in a specific task or business process. In fact, the potential usefulness of the RA(S)CI model in applying profit split method was briefly touched upon in the OECD's 2014 Public Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains.[240]

Nevertheless, it should be noted that the development of the RA(S)CI matrix relies on a substantial amount

229. Verlinden, De Baets & Parmessar, *supra* n. 203, at 1048.
230. G. Vallat, *Application of the DEMPE Concepts in the Pharmaceutical Industry*, 27 Intl. Transfer Pricing J. 3, 12 (2020), Journal Articles & Papers IBFD.
231. Verlinden, De Baets & Parmessar, *supra* n. 203, at 1049.
232. Vallat, *supra* n. 230, at 12.
233. Id., at 12.
234. Id., at 14.
235. Id., at 13.
236. Id.
237. Id., at 7.
238. Id.
239. Peng & Lagarden, *supra* n. 228, at 7-9.
240. OECD/G20, *Public Discussion Draft – BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains, 16 December 2014-6 February 2015* para. 38 (OECD 2014), Primary Sources IBFD.

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of business judgement in identifying the major contributing entities, and, therefore, does not represent a bulletproof economic study.[241] Indeed, according to Peng & Lagarden (2019), the RA(S)CI model cannot replace a comprehensive and sound arm's length analysis, and it is unlikely that tax authorities would accept a TP analysis relying solely on a RA(S)CI model.[242]

Besides the subjective character of the RA(S)CI model, the use of this type of model for analysing DEMPE functions would be at odds with the ALP, as a higher weight is assigned to classification as "responsible" than as "accountable", whereas the ALP under the OECD Guidelines (2017) gives greater importance to management and control (i.e. accountability) of DEMPE functions, rather than merely their performance (i.e. responsibility).[243] Moreover, the application of the RA(S)CI model is an elaborate and time-consuming exercise, as well as an expensive process in relation to the budgets of all but the largest MNEs.[244] As a final point, using such qualitative outcomes as a proxy for quantitative outcomes will surely lead to a plethora of tax disputes.

5.2.3. Enhanced use of the Master File

As described above, the application of the DEMPE method based on value creation, functions and risk allows more jurisdictions to claim part of the profits from intangible activities derived by an MNE group. In this respect, country-by-country (CbC) reporting, as part of three-tiered approach to TP documentation together with the Master File and Local File proposed in the BEPS Action 13 Final Report, can reduce the asymmetry in information among various countries and mitigate the risk of double taxation that arises as a result of the different evaluation of the facts relating to transactions involving intangibles.[245]

The OECD states that the CbC report can be used only to perform a high-level TP risk assessment, and that the information included therein must not be used by the tax administrations of the various countries to propose TP adjustments based on a global formulary apportionment of income.[246] Nevertheless, the CbC report template could serve as a useful starting point for ascertaining whether a profit split method should be undertaken,[247] and for the tax administration to obtain and exchange information which may facilitate the assessment of intra-group transactions involving intangibles. For example, the CbC report can indicate mismatches between the intangibles owned by an entity of an MNE group, the functions actually performed and the profit/revenues realized.

This said, while the CbC report is more a high-level risk assessment tool, the Master File serves as the "blueprint" for a TP audit and, therefore, can play a better role in the documentation of DEMPE functions.[248] The Master File should provide an overview of the MNE group's business, including the nature of its global business operations, its overall TP policies, and its global allocation of income and economic activity, in order to allow tax administrations to better assess the presence of significant TP risk.[249] The Master File should include the following information: the MNE group's organizational structure, description of the MNE's business and its value drivers, the MNE's supply chain model, the MNE's intangibles, the MNE's intercompany financial activities and the MNE's financial and tax positions.[250] With respect to intangibles, the Master File should provide information about strategy and process as well as the teams/roles/departments in charge of key functions such as the creation, ownership, protection and development and exploitation of valuable intangible assets. Documentation of the DEMPE functions may be quite burdensome, and this would increase the level of information and detail to be included in the Master File.[251]

Considering the high risk of disputes between tax administration and MNEs with respect to the identification and compensation of DEMPE functions, it is strongly advisable for MNEs to have teams in charge of collecting appropriate information on the DEMPE functions and to transfer this information into the Master File and potentially into the Local Files.[252] In this respect, as the Master File serves as defensive support for a TP audit more than does a CbC report, it would be helpful to have additional guidance from the OECD or local tax authorities on what a best-practice description of the DEMPE functions in the Master File should look like.[253]

241. Id.
242. Peng & Lagarden, *supra* n. 228, at 9.
243. T. Keen, *The Compensation of DEMPE Control Functions in Post-BEPS Transfer Pricing*, Duff & Phelps Transfer Pricing Times – Second Quarter 2020 (15 July 2020), available at https://www.duffandphelps.com/insights/publications/transfer-pricing/transfer-pricing-times-second-quarter-2020/compensation-dempe-control-functions-transfer-pricing (accessed 20 Oct. 2020).
244. Id.
245. J. Hey, *"Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative*, 72 Bull. Intl. Taxn. 4/5, 207 (2018), Journal Articles & Papers IBFD.
246. *OECD Guidelines* (2017), *supra* n. 2, at para. 5.25.
247. V. Chand & S. Wagh, *The Profit Split Method: Status Quo and Outlook in Light of the BEPS Action Plan*, 21 Intl. Transfer Pricing J. 6, 408 (2014), Journal Articles & Papers IBFD.
248. Verlinden, De Baets & Parmessar, *supra* n. 203, at 1055.
249. *OECD Guidelines* (2017), *supra* n. 2, at para. 5.18.
250. Id.
251. Verlinden, De Baets & Parmessar, *supra* n. 203, at 1054.
252. Id., at 1055.
253. Id.

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5.2.4. Dispute prevention mechanisms

5.2.4.1. Preliminary remarks

The new TP guidance will likely result in a higher risk of double taxation. In order to avoid legal uncertainty, massive administrative burden and high costs, MNEs should try to avoid entering into risky tax controversy procedures that rely mostly on dispute resolution mechanisms. Instead, MNEs should try to prevent disputes by focusing on cooperative compliance and, where, possible, on concluding advance pricing agreements (APAs) with the tax authorities of the countries involved in transactions relating to intangibles. This section focuses mostly on such prevention mechanisms as opposed to resolution mechanisms.[254]

5.2.4.2. Cooperative compliance

Pursuant to the BEPS project, commercial and economic understanding of the taxpayer's business is becoming increasingly important.[255] Cooperative compliance is one way in which tax administrations can address these challenges, as it offers tax administrations a way to encourage greater voluntary compliance and a way to obtain a greater understanding of how MNEs operate, make decisions and manage their tax exposure.[256]

The concept of cooperative compliance is intended to refer to quality compliance, which means payment of taxes due on time in an effective and efficient manner.[257]This concept relies on a trustful relationship between the taxpayer and the tax administration, within which the taxpayer can be trusted and the tax administration behaves predictably and provides "comfort" and "assurance" regarding tax positions.[258]Cooperative compliance is therefore based on the assumption that, if a taxpayer voluntarily abides by the rules and is transparent and able to support the tax positions declared, the relevant tax administration should, in return, provide certainty regarding a tax position in advance.[259]

Several countries have developed the concept of cooperative compliance in their tax law and have implemented cooperative compliance programmes (e.g. Italy, the Netherlands and the United States). Although some of these jurisdictions share many common features, there are also important differences between the various countries.[260] Some of these programmes have been implemented through a specific statutory framework, while others have been embedded in an existing legal framework, supplemented, in some cases, by formal agreements with participating taxpayers.[261] Overall, the implementation of these programmes has resulted in benefits for taxpayers and tax administrations, even though the experience shows that in order to make the programs fully successful it is necessary to tailor their design to the specific features of the legal and institutional frameworks of the respective country.[262]The OECD has recently highlighted the importance of shifting focus from dispute resolution to dispute prevention by ensuring that disagreements between tax administrations can be resolved quickly to avoid double taxation: cooperative compliance could be the answer to this issue.[263]

In March 2019, the OECD launched the second International Compliance Assurance Programme (ICAP) pilot, which is a voluntary multilateral cooperative risk assessment and assurance process. It is designed to be an efficient, effective and coordinated approach, providing MNEs willing to engage actively, openly and in a fully transparent manner with increased tax certainty with respect to some of their activities and transactions.[264] ICAP does not provide an MNE with the same degree of legal certainty as may be achieved through an APA.[265] It does, however, give comfort and assurance where tax administrations participating in an MNE's risk assessment consider a covered risk to be low risk.[266] Where an area identified within the ICAP needs further attention, work conducted in ICAP can, if needed, improve the efficiency of actions taken outside the programme.[267] Nevertheless, when cooperative compliance cannot provide comfort and assurance because risks are not

254. Further to issuance of the BEPS Action 14 Final Report, the OECD decided to introduce a mandatory binding arbitration provision under part VI of the Multilateral Instrument (2017) (MLI). The provision in the MLI is similar to article 25(5) of the OECD Model. However, as the mandatory binding arbitration provision of the MLI is optional for the signatory countries, only approximately one third of the signatories of the MLI decided to apply it. *See* IMF/OECD, *2019 Progress Report on Tax Certainty* 6 (IMF/OECD 2019), available at http://www.oecd.org/tax/tax-policy/g20-report-on-tax-certainty.htm (accessed 20 Oct. 2020) [hereinafter *IMF/OECD 2019 Progress Report*].
255. J.L. Pemberton & A. Majdańska, *Can Cooperative Compliance Help Developing Countries Address the Challenges of the OECD/ G20 Base Erosion and Profit Shifting Initiative?*, 70 Bull. Intl. Taxn. 10, 595 (2016), Journal Articles & Papers IBFD.
256. Id.
257. E.M.E. van der Enden & K. Bronżewska, *The Concept of Cooperative Compliance*, 68 Bull. Intl. Taxn. 10, 567 (2014), Journal Articles & Papers IBFD.
258. Id.
259. Id.
260. Pemberton & Majdańska, *supra* n. 255, at 595.
261. Id.
262. Id.
263. *IMF/OECD 2019 Progress Report*, *supra* n. 254, at 6.
264. OECD, *International Compliance Assurance Programme: Pilot Handbook 2.0* 5 (OECD 2019), available at http://www.oecd.org/tax/forum-on-tax-administration/publications-and-products/international-compliance-assurance-programme-pilot-handbook-2.0.pdf (accessed 20 Oct. 2020).
265. Id.
266. Id.
267. Id.

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low risks, an MNE should consider instruments such as bilateral or multilateral APAs.

5.2.4.3. Bilateral/multilateral APAs (MAP APAs)

In order to reduce the level of subjectivity of tax administrations in assessing the outcome of TP analyses related to intangibles, the OECD as well as the legislators and tax administrations of the various member countries can introduce mandatory rulings and bilateral or multilateral APAs between tax administrations and companies. An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the TP for those transactions over a fixed period of time.[268] An APA initially requires a formal application by a taxpayer, and entails negotiations between the taxpayer, one or more associated enterprises and one or more tax administrations.[269]

APAs may be used to secure the appropriateness of a TP methodology or result for a certain number of years by relying on forecasts and predictions. The reliability of a prediction depends on the facts and circumstances of each actual case. Therefore, taxpayers and tax administrations need to pay close attention to the reliability of a prediction when considering the scope of an APA.[270]

It is important to distinguish the different types of APAs: unilateral APAs, and bilateral or multilateral APAs (also referred to as MAP APAs). APAs that do not involve a mutual agreement procedure (MAP) are referred to as unilateral APAs.[271] Unlike unilateral APAs, bilateral and multilateral APAs substantially reduce or eliminate the possibility of juridical or economic double or non-taxation, as all the relevant countries participate in the arrangement.[272]

APAs are mostly adopted for cases in which the application of TP rules gives rise to doubts and difficulties, as may occur in applying the DEMPE approach. Even though the OECD Model (2017) provides for TP adjustments, it does not indicate any particular methodologies or procedures other than the ALP as set out in article 9.[273]Thus, it could be considered that APAs are authorized by paragraph 3 of article 25 of the OECD Model, because the specific TP cases subject to an APA are not otherwise provided for in the OECD Model.[274]In particular, the OECD and the legislators of the various member countries could consider introducing mandatory bilateral or multilateral APAs for specific TP cases related to transactions involving intangibles in order to provide more certainty in applying the DEMPE approach.

As many countries have experienced difficulties and incurred high costs in the resolution of TP disputes by conducting traditional audit or examination techniques, a MAP procedure involving APAs has been developed.[275] This process should be distinguished from the MAP procedure under article 25(1) of the OECD Model (2017), which is a procedure for resolving disputes arising from the interpretation or application of the tax treaty (but also from the interpretation or application of domestic tax laws, to the extent that the tax treaty refers to such laws). On the other hand, the MAP APA process has the objective of reducing the risk of potential double taxation and proactively preventing TP disputes.[276]

The MAP APA procedure could significantly reduce the time needed to reach an agreement, as the competent authorities are dealing with current data as opposed to prior year data that may be difficult and time-consuming to produce.[277] Furthermore, concluding APAs through the MAP procedure may be the only method that can be adopted by a tax administration that lacks authorization in domestic legislation to enter into binding agreements with the taxpayer (inasmuch as double tax treaties take precedence over domestic law).[278]

5.2.4.4. Role of dispute prevention in the application of the DEMPE approach

Cooperative compliance and MAP APAs could be useful instruments to facilitate the application of the DEMPE method in cross-border transactions involving intangibles, in order to avoid misalignments among tax administrations which may result in potential double taxation and/or disputes. For example, multilateral cooperative compliance could allow an MNE to obtain a preliminary assessment from different tax administrations of the TP risks related to transactions involving intangibles in which the entities having the legal ownership and funding the intangible do not perform the DEMPE functions. This would require a transparent exchange of information between the tax administrations and MNEs, in which the legal agreements, functional analyses and other relevant TP documentation were provided on a continuous basis to the tax authorities in return for a prompt feedback in terms of preliminary risk assessment.

In addition, a bilateral or multilateral APA could allow certainty in complex matters such as: (i) the split of the residual profits to be allocated to companies performing DEMPE functions when those functions

268. OECD Guidelines (2017), *supra* n. 2, at para. 4.134.
269. Id.
270. Id., at para. 4.135.
271. Id., at annex II to chapter VI, 473.
272. Id., at para. 4.156.
273. Id., at para. 4.150.
274. Id.
275. Id., at annex II to chapter VI, 474.
276. Id., at annex II to chapter VI, 475.
277. Id.
278. Id., at para. 4.173.

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are performed by multiple entities resident in different countries; (ii) the valuation/pricing applied in a cross-border transfer of intangible assets; or (iii) the confirmation by various tax authorities of the functional profile, the risks assumed and the remuneration to be derived by an entity resident in the relevant country following a restructuring or a redeployment of DEMPE functions within a MNE group. It would be desirable that the OECD and the legislators of the various member countries could enforce mandatory valuation rulings and bilateral or multilateral APAs for certain cross-border transactions involving intangibles.

6. Interaction between DEMPE and Pillars One and Two of the Digitalization Project

6.1. Value creation and "source" rules

The question analysed in this section is where the DEMPE concept fits within the present debate on the digitalization of the economy. At the outset, it should be noted that the ALP, as updated by BEPS Actions 8-10, was intended to ensure that profit allocation among states is consistent with value creation.[279] However, as the meaning of that concept was never clarified by the OECD, it has received significant academic attention.[280] In fact, the concept has been extensively criticized.[281]

Putting aside the criticism, it is the present authors' opinion that the value creation concept does the job of a "source"[282] rules, determining the countries that are allowed to tax an enterprise's cross-border business income. To elaborate, under the current framework, business income is generally "sourced" in the state where an enterprise conducts business or economic activities with its production factors (such as employees).[283].

The history of the current framework can be traced back to the work undertaken by the League of Nations.[284] The League of Nations, represented by four economists, concluded that income of business enterprises/commercial establishments should be taxed in the state where an enterprise has its "origin".[285] "Origin" was defined as the place where "earnings are created" by human agency.[286] In the early 21st century, the OECD once again discussed this framework[287]and concluded that the international corporate tax base should be allocated among states[288] based on the "supply" approach (which is based on production factors) as opposed to a "supply-demand" approach (which is based on production and demand factors). It seems that the BEPS project has also reinforced the application of the "supply" framework, as several Actions of the BEPS plan have reinforced the application of activity-based concepts. For example, BEPS Actions 8-10 now provide detailed guidance on the concept of control over risk and DEMPE; BEPS Action 5 introduced

279. Wittendorff, *supra* n. 5, at 331.
280. Hey, *supra* n. 245, at 203.
281. For recent criticism, *see* W. Haslehner & M. Lamensch, *General Report*, in *Taxation and Value Creation* (W. Haslehner & M. Lamensch eds., IBFD forthcoming 2021), Books IBFD.
282. This said, as rightly pointed out by Prof. Wilkie, "there is no universal understanding or agreement concerning the source of income". *See* J.S. Wilkie, *An Inverted Image Inspires a Question: Comments on Professor Ulrich Schreiber's "Sales-Based Apportionment of Profits"*, 72 Bull. Intl. Taxn. 4/5 (2018), Journal Articles & Papers IBFD.
283. *See* V. Chand, *Allocation of Taxing Rights in the Digitalized Economy: Assessment of Potential Policy Solutions and Recommendation for a Simplified Residual Profit Split Method*, 47 Intertax 12 (2019). *See also* K. Vogel, *Worldwide vs. Source Taxation of Income: A Review and Re-Evaluation of Arguments (Part II)*, 16 Intertax 10, 320 (1988); K. Vogel, *Worldwide vs. Source Taxation of Income: A Review and Re-Evaluation of Arguments (Part III)*, 16 Intertax 11, 398 (1988); A. Schäfer & C. Spengel, *ICT and International Taxation: Tax Attributes and Scope of Taxation*, Discussion Paper 02-81 (Centre for European Economic Research 2002); E.C.C.M. Kemmeren, *Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach*, 60 Bull. Intl. Taxn. 11, 433-437 (2006), Journal Articles & Papers IBFD; M. Devereux, *Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations*, 24 Oxford Rev. Econ. Policy 4, 712-715 (2008); L.U. Cavelti, C. Jaag & T.F. Rohner, *Why Corporate Taxation Should Mean Source Taxation: A Response to the OECD's Actions Against Base Erosion and Profit Shifting*, 9 World Tax J. 3, 352-354 (2017), Journal Articles & Papers IBFD; W. Schön, *Ten Questions about Why and How to Tax the Digitalized Economy* 22, Max Planck Institute for Tax Law and Public Finance Working Paper 2017-11 (2018); and J. Becker & J. Englisch, *Taxing Where Value Is Created: What's "User Involvement" Got to Do with It?*, 47 Intertax 2, 163-164 (2019).
284. G.W.J. Bruins et al., *Report on double taxation: Submitted to the Financial Committee*, E.F.S.73.F.19 (League of Nations 1923).
285. Id., at 29-32 and 39-40.
286. Id., at 22-25. These findings were reiterated in subsequent reports produced by the League of Nations, as well as in draft conventions for the prevention of double taxation. *See* League of Nations, *Double Taxation and Tax Evasion Report and Resolutions submitted by the Technical Experts to the Financial Committee*, F.212, 31 (League of Nations 1925); League of Nations, *Draft of a Bilateral Convention for the Prevention of Double Taxation and Tax Evasion: Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, C.216.M.85.1927.II, 10-11 and 15 (League of Nations 1927); League of Nations, *Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, C.562.M.178.1928.II, 8-9 and 12-13 (League of Nations 1928); League of Nations Fiscal Committee, *Report to the Council on the Work of the First Session of the Committee*, C.516.M.175.1929, 4 (League of Nations 1929); League of Nations Fiscal Committee, *Report to the Council on the Work of the Second Session of the Committee*, C.340.M.140, 8 (League of Nations 1930); League of Nations Fiscal Committee, *Report to the Council on the Work of the Fifth Session of the Committee: Purposes of Taxation*, C.252.M.124, 5 (League of Nations 1935); League of Nations Fiscal Committee, *London and Mexico Model Tax Conventions: Commentary and Text*, C.88.M.88.1846.II.A, 13-21 and 60 (League of Nations 1946); OEEC, *The Elimination of Double Taxation: The First Report of the Fiscal Committee* 6-7 (OEEC 1958). All of these reports are available at http://www.taxtreatieshistory.org/ (accessed 27 July 2019).
287. OECD, *E-Commerce: Transfer Pricing and Business Profits Taxation* (OECD 2005).
288. Id, at para. 40.

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the substantial activities test;[289] and BEPS Action 6[290] provides that treaty benefits will be granted only to taxpayer structures that are linked to core commercial activity.[291] Thus, in the present authors' view, if a corporate taxpayer's personnel, such as employees, performs relevant activities only in Country R (assuming Country R is also the state of its tax residence), then business income derived from those activities should prima facie be taxed only in that state under tax treaty and TP rules.[292]

On the other hand, from a corporate tax perspective, when Company R from Country R conducts business in Country S through "origin", "supply", or "value creation" factors therein (such as its employees), then the latter state taxes the income linked to those factors.[293] From a legal taxable nexus perspective, the value creation factors in Country S could either be a part of the same enterprise (such as a PE)[294] or a separate related entity. From a profit allocation perspective, TP rules are typically employed to allocate profits to the separate related entity[295] or to the PE.[296]

As discussed in section 2., in relation to the framework applied for the purpose of the allocation of the profits derived from intangibles, the ALP allocates profits, firstly, by accurately delineating the transaction/dealing (in other words, understanding the value generated by the value creation factors – which could be different from transaction to transaction or dealing to dealing); and secondly, by looking into comparable transactions (pricing the value linked to the value creation factors). This analysis indicates that a state can tax the business income of an enterprise to the extent that the enterprise performs value-creating functions therein. In order words, the concept shows that the profits of "empty entities" can be reallocated to countries where real value is created. In this sense, the concept acts as a "negative source" rule,[297] as the state where "empty entities" are set up is not permitted to tax the income derived from the legal configurations operating in their state.

Alongside its role in attributing profits to the places where activities are carried out physically, the value creation concept has also been used to argue for the development of a "positive source" rule.[298] Indeed, with the rise of digitalization, policymakers are currently being confronted with the issue of how a user/market country can tax the business income of an enterprise operating in the digital space. While this issue was being debated heavily in academic and policymaking circles in 2019, the OECD issued a Public Consultation Document[299] offering the following three solutions: the user participation (UP) approach, the marketing intangibles (MI) approach and the significant economic presence (SEP) approach. Of these three approaches, the first two were linked to the value creation concept. The UP proposal argued that the user creates value and not the activities of the firm itself. This proposition should be dismissed. The MI proposal, on the other hand, argued that the activities of a firm create intangible value in the minds of the customers/users and proposes to tax such intangible value. This line of thinking stays within the boundaries of the value creation concept. In the latter part of 2019, these approaches were merged in the OECD's Proposal for a Unified Approach under Pillar One (Pillar One proposal),[300] which comprises Amounts A and B.[301] One can raise the question of whether the unified approach (Amount A) is consistent with the value creation standard (as the present authors understand it).

On the one hand, it could be argued that Amount A goes beyond the value creation standard because it incorporates elements of all three proposals, especially, using a formulary approach as proposed under the SEP proposal. On the other hand, it could be argued that, out of these three proposals, from a conceptual

289. OECD/G20, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report* ch. 4 (OECD 2015), Primary Sources IBFD.
290. OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2015 Final Report* (OECD 2015).
291. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 29* para. 181 (21 Nov. 2017), Treaties & Models IBFD.
292. V. Chand & B. Malek, *The Relevant Economic Activity Test and Its Impact on International Corporate Tax Policy*, British Tax Rev. 3 (2019); E.C.C.M. Kemmeren, *If we need a Destination-Based Corporate Income Tax, do we also need a Production-Based Consumption Tax?*, in *International Taxation in a Changing Landscape – Liber Amicorum in Honour of Bertil Wima* 154-156, Series on International Taxation vol. 71 (J. Monsenego & J. Bjuvberg eds., Kluwer Law International 2019). Collier states that the concept of value creation is quite clear, and that it relates to activities performed in a country: *see* R. Collier, *The Value Creation Mythology*, in Taxation and Value Creation (W. Haslehner & M. Lamensch (eds.), IBFD forthcoming 2021), Books IBFD.
293. D. Pinto, *E-Commerce and Source-Based Income Taxation* sec. 2.2.1. (IBFD 2003), Books IBFD.
294. *See* art. 5 *OECD Model* (2017).
295. Id., at art. 9(1).
296. Id., at art. 7(2). *See also OECD 2010 Report*, *supra* n. 129, which provides detailed guidance in the interpretation of art. 7(2) *OECD Model*; and *OECD Model Tax Convention on Income and on Capital: Commentary on Article 7* paras. 8–9 (21 Nov. 2017), Treaties & Models IBFD.
297. J.S. Wilkie, *New Rules of Engagement? Corporate Personality and the Allocation of "International Income" and Taxing Rights*, in *Tax Treaties after the BEPS Project – A Tribute to Jacques Sasseville* 357-371 (B.J Arnold ed., Canadian Tax Foundation 2018). *See also* A.J. Martín Jiménez, *Value Creation: A Guiding Light for the Interpretation of Tax Treaties?*, 74 Bull. Intl. Taxn. 4/5. 207-214 (2020), Journal Articles & Papers IBFD.
298. Martín Jiménez, *supra* n. 297, at 200-207.
299. OECD/G20, *Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy, 13 February-6 March 2019* (OECD 2019), Primary Sources IBFD.
300. OECD, *Public Consultation Document: Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October-12 November 2019* (OECD 2019) [hereinafter *Secretariat Proposal*].
301. Id.

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perspective Amount A seems to be built on the MI proposal. To elaborate, the value creation standard should, to begin with, be seen from a supplier's (firm's) perspective. This would imply that the standard clearly permits taxation in the state where the firm performs its activities with its personnel (as discussed earlier in this section). This also implies that the standard permits taxation in the user/market country to the extent that the non-resident supplier has created value in that state. Indeed, it is reasonable to state that many MNEs currently create "intangible" value in the user/market country as a result of their own efforts. Some highly digitalized businesses, in particular those operating as online advertisers, create user networks (which are currently intangible in nature). Other MNEs, as a result of their own efforts (especially marketing efforts), create marketing intangibles such as goodwill (which is also a sort of an intangible).[302] Vann (2010) has argued that these intangibles "(particularly in business-to-consumer sales)... are inherently connected to the sales market".[303] Arguably, under the current international corporate tax framework, in most circumstances, the value of these intangible assets that is linked to the user/market country is not taxed. In other words, income that can be "sourced" to the user/market countries escapes taxation. As Amount A seeks to allocate a part of the MNE's residual profits to user/market countries, it seems consistent with the value creation standard. If this is the case, and if the value linked to these intangibles is taxed in the market country under the current ALP framework (Amount C), then an overlap could arise, and this would need to be mitigated (although it is difficult, if not impossible, to ascertain how much of the value is taxed). Against this backdrop, it is now possible to return to the question of the role of the DEMPE concept within the debate on the digitalization of the economy.

6.2. Pillar Two: GloBE proposal

6.2.1. The issue of profit shifting and tax competition under the DEMPE approach

In the context of transactions involving intangibles, the concept of "value creation" can be considered an approach aimed at allocating profits in accordance with the performance of key DEMPE activities. Essentially, the concept, as a negative source rule, indicates that the profits of "empty IP entities" can be reallocated to countries where value is created. In this sense, a state where "empty IP entities" are set up is not permitted to tax the income generated by the IP, and a state where "limited functional IP entities" are set up is not permitted to tax a major portion of the income generated by the IP.

A consequence of the above is that the DEMPE approach could create opportunities for tax planning. As the DEMPE approach is linked to people functions, it is obvious that MNEs could engage in profit shifting activities by moving key decision-making staff (mobile factors) to low-tax jurisdictions (along with capital). The 2018 report of the OECD Inclusive Framework on BEPS already provides evidence that MNEs have aligned their activities with the BEPS substance requirements.[304]Moreover, by centralizing decision-making (over R&D and financing) in low-tax enterprises, intangible profits could be shifted to a low-tax country without the legal transfer of the intangibles, and moreover without exit taxation (in some cases).[305] Indeed, if an MNE legally owning intangibles in a jurisdiction where no DEMPE functions are performed wants to recognize profits in another jurisdiction, based on the DEMPE method, it would not necessarily need to perform a legal transfer of the intangibles. Also, when looking at the actual conduct of the parties and applying the "economic approach" based on DEMPE, the transfer of any DEMPE functions to another jurisdiction, without transferring the legal ownership of the IP, may not necessarily entail exit taxation if the transferring jurisdiction does not have taxing rights based on the domestic tax law to tax a potential capital gain upon exit. Therefore, the OECD Guidelines (2017), being based on the DEMPE approach, do not prevent genuine profit shifting.

At the same time, it seems that the BEPS project (including the DEMPE approach) has intensified tax competition among states. Countries can engage in tax competition in order to attract mobile factors (people functions coupled with capital) by, for example, reducing corporate tax rates or offering preferential tax regimes to stimulate innovation and investment.[306]The OECD, in its 2018[307]and 2019[308]reports on tax policy reforms, has indicated that several countries around the world have reduced corporate tax rates as a response to the BEPS project. In particular, the 2018 report states that that "countries appear to be engaged in a 'race to the average' rather than in a 'race to the bottom', with their recent corporate tax rate cuts

302. P. Oosterhuis & A. Parsons, *Destination Based Income Taxation: Neither Principled Nor Practical?*, 71 Tax Law Rev., 522-524 (2018).
303. R.J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 World Tax J. 3 (2010), Journal Articles & Papers IBFD.
304. OECD/G20, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* 153 (OECD 2018), Primary Sources IBFD.
305. Wittendorff, *supra* n. 5, at 332.
306. P. Piantavigna, *Tax Competition and Tax Coordination in Aggressive Tax Planning: A False Dichotomy*, 9 World Tax J. 4, 477-496 (2017), Journal Articles & Papers IBFD.
307. OECD, *Tax Policy Reforms 2018: OECD and Selected Partner Economies 66-67* (OECD 2018) [hereinafter *Tax Policy Reforms 2018*].
308. OECD, *Tax Policy Reforms 2019 OECD and Selected Partner Economies* sec. 3.2. (OECD 2019) [hereinafter *Tax Policy Reforms 2019*].

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now placing them in the middle of the pack".[309] The 2019 report also indicates that many countries have enhanced their existing tax incentives or introduced new ones – in particular, modified nexus-based IP boxes to stimulate innovation.[310] This phenomenon of profit shifting and tax competition is nothing new. As long as corporate tax is linked to mobile factors, MNEs will continue to engage in profit shifting and states will continue to engage in tax competition.

6.2.2. The authors' perspective

While the policy objective of the Pillar Two proposal, also referred to as the Global Anti-Base Erosion or GloBE proposal,[311] is not entirely clear, it is obvious that it seeks to address profit shifting and tax competition challenges by ensuring that the profits of internationally operating businesses are subject to a minimum rate of tax.[312] It presupposes that a minimum tax rate on all income reduces the incentive for taxpayers to engage in profit shifting, and establishes a floor for tax competition among jurisdictions. With respect to the latter, the GloBE proposal posits that global action is needed to stop the downward spiral of corporate taxes.

The recently issued Report on the Pillar Two Blueprint[313] confirms that the proposal will apply to MNE groups[314] that exceed a consolidated revenue threshold of EUR 750 million.[315] Moreover, the report confirms that Pillar Two contains four key components: an income inclusion rule (including a switch-over rule), an undertaxed payment rule and a subject-to-tax rule. Of these, the main instruments for combating profit shifting and tax competition seems to be the income inclusion rule and the subject-to-tax rule. Interestingly, the subject-to-tax rule applies before the income inclusion rule.[316]

The question arises of whether the proposal restricts MNEs from shifting their profit (including key DEMPE functions) to low-tax jurisdictions or countries in order to attract mobile functions (including key DEMPE functions). The answer to this question would depend on the method adopted to determine the effective tax rate (ETR) to apply the income inclusion/undertaxed payments rule. As a reminder, ETR is the tax paid[317] divided by the profit before tax.[318]

The first design consideration is whether the rule would apply on a global blending basis or a jurisdictional blending basis. If the former, then profit shifting and tax competition may still thrive, as the figures for taxes paid and profit before taxes earned in all jurisdictions (both high tax and low tax) are blended to determine the ETR. If the latter, profiting shifting and tax competition could be restricted to a certain extent. In fact, the Report on the Pillar Two Blueprint prefers a jurisdictional blending approach.[319] At this stage, it is important to highlight that the jurisdictional blending approach is extremely complex, and, thus, simplification will need to be considered in this area if this approach represents the way forward.

A second consideration relates to how a "substance-based" approach will be addressed under Pillar Two. The question is whether all substance-based activities should be outside the scope of the proposal under a facts or circumstances carve-out mechanism, or whether only those substance-based activities should be out of scope that are availing themselves of preferential regimes that have been approved by the Forum on Harmful Tax Competition (i.e. Action 5-compliant regimes). In the present authors' opinion, the GloBE proposal should either be premised on an approach that looks only at ETRs, or else should rely on a "comprehensive" substance carve-out. A partly balanced approach, i.e. an approach that carves out BEPS Action 5 situations but not BEPS Actions 8-10 situations, is incoherent and clearly non-neutral. The Report on the Pillar Two Blueprint moves in this direction and indicates a preference for no substance-based carve-outs as such. However, the report discusses the possibility of a formulaic substance-based carve-out based on payroll and depreciation of tangible assets (i.e. a return on tangible assets carve-out similar to the one contained in the US global intangible low-taxed income rules).[320] In the present authors' opinion, such a carve-out adds complexity to the proposal and to its effective implementation. Once again, simplification will need to be explored in this area if this approach represents the way forward.

Overall, in light of the above discussion on the two considerations, the present authors believe that a balance needs to be struck between the aim of combating

309. OECD, *Tax Policy Reforms 2018*, *supra* n. 307, at 9-10.
310. OECD, *Tax Policy Reforms 2019*, *supra* n. 308, at sec. 3.2.
311. OECD/G20, *Public Consultation Document: Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two, 8 November 2019-2 December 2019* (OECD 2019).
312. OECD/G20, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy – Inclusive Framework on BEPS* 25 (OECD 2019).
313. OECD, *Tax Challenges Arising from Digitalisation: Report on Pillar Two Blueprint– Inclusive Framework on BEPS* (OECD 2020), available at https://doi.org/10.1787/abb4c3d1-en (accessed 6 Nov. 2020) [hereinafter *Report on the Pillar Two Blueprint*].
314. For a definition of an MNE group and for businesses within scope, *see* id., at 22-40.
315. For determining this threshold, *see* id., at 40-42.
316. For an example, *see* id., at 240-243.
317. For an understanding of the taxes covered by this proposal, *see* id., at 44-50.
318. For an understanding of the manner in which the taxable base will be determined, *see* id., at 50-71.
319. Id., at pp. 71-79. *See also* R. Danon & V. Chand, *Addressing the Tax Challenges of the Digitalisation of the Economy – Comments on the Public Consultation Document* (6 Mar. 2019) 17-18, available at https://serval.unil.ch/resource/serval:BIB_9283B6869EAC.P001/REF (accessed 20 Oct. 2020).
320. Id., at 91-99.

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tax competition and that of achieving an administrable system for both taxpayers and tax administrations. Thus, the preferred option would be the adoption of a global blending approach without any carve-outs, as this represents a simpler system wherein compliance costs would be lower for both taxpayers and tax administrations.

Leaving aside these two considerations, it is the authors' view that the GloBE proposal cannot eliminate the tax factor from international economic rivalry. It may curb the "race to the bottom" or "to the average", but there will still be room for profit shifting and tax competition above the GloBE proposal's minimum rate. Overall, it may well be possible that the Pillar Two proposal may discourage MNEs from redeploying key DEMPE functions related to intangible assets to a low-tax jurisdiction, as these rules could increase ETR burdens. The OECD's report on the economic assessment on both pillars[321] confirms this conclusion, stating that

> indeed, Pillar Two would reduce the differences in effective tax rates across jurisdictions, which are one of the main drivers of profit shifting. *Reducing these tax rate differentials would reduce MNEs' incentives to shift profit to low-tax jurisdictions.* This would likely lead MNEs to reassess their profit shifting strategies, and some MNEs would likely consider that the gains of certain profit shifting schemes would no longer be worth the costs (e.g. financial and advisory costs of the schemes, reputational costs, etc.). The exact scale of the reduction in profit shifting and location of profits in a post Pillar Two world are difficult to anticipate with certainty as profit shifting schemes are very complex and firm-specific. Nevertheless, the reduction of profit shifting is expected to contribute significantly to the global revenue gains from Pillar Two. [Emphasis added.]

6.3. *Pillar One: Allocation of taxing rights to market countries*

6.3.1. *Summary of Pillar One*

This section is developed on the basis of the Statement on the Two-Pillar Approach by the Inclusive Framework on BEPS, issued in January 2020,[322] and the recent Report on the Pillar One Blueprint,[323] as well as the literature on this matter.[324]

On the scope side, the Pillar One proposal applies to automated digital businesses (ADSs) such as businesses that are engaged or involved in online advertising services; the sale or other alienation of user data; online search engines; social media platforms; online intermediation platforms; digital content services; online gaming; standardized online teaching services; and cloud computing services.[325] The proposal also applies to consumer-facing businesses (CFBs). Common examples include businesses dealing in food and beverages; personal goods (e.g. luxury goods, fashion goods, consumer electronics, hygiene and health care goods, tobacco); household goods (e.g. household furnishings, appliances or cleaning products); automobiles (e.g. cars, motorcycles, bicycles); pharmaceuticals (e.g. medicines for individual consumption); also businesses whose core activity is wholesaling or retailing goods (foods, drugs, clothes, etc.); and businesses engaged in franchising.[326] The Report on the Pillar One Blueprint discusses the application of the CFB definition to some of these businesses, and in particular its application in borderline cases.[327]

In terms of exclusions, it is clarified that businesses that do not fall under the ADS definition include customized professional services; customized online teaching services; businesses engaged in online sale of goods and services other than ADS; the Internet of things; and services providing access to the Internet or another electronic network.[328] Nonetheless, some of these businesses could fall within the CFB category. At the same time, other businesses are excluded, such as businesses engaged in the extractive sector, financial services, construction businesses and shipping and airlines businesses.[329] Moreover, the blueprint confirms that the proposal will apply to MNE groups that exceed a consolidated revenue threshold of EUR 750 million (at least as a start), as well as to MNEs that pass a foreign in-scope revenue test.[330]

For businesses within scope, new nexus rules are largely based on sales.[331]Additionally, some additional physical factors are under consideration for defining CFBs.[332] Detailed revenue sourcing rules are provided to determine the market/user country to which the revenues (as well as the profits) will be sourced.[333]

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321. OECD/G20, *Tax Challenges Arising from Digitalisation: Economic Impact Assessment – Inclusive Framework on BEPS* sec. 1.2.2 (OECD 2020), available at https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-economic-impact-assessment-0e3cc2d4-en.htm (accessed 6 Nov. 2020).
322. OECD/G20, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy – January 2020* (OECD 2020) [hereinafter *Statement on the Two-Pillar Approach*].
323. OECD/G20, *Tax Challenges Arising from Digitalisation: Report on Pillar One Blueprint – Inclusive Framework on BEPS* (OECD 2020), available at https://doi.org/10.1787/beba0634-en (accessed 5 Nov. 2020) [hereinafter *Report on the Pillar One Blueprint*].
324. In particular, *see* R. Danon & V. Chand, *Comments to Public Consultation Document: Secretariat Proposal for a "Unified Approach" under Pillar One* (12 Nov. 2019), available at https://serval.unil.ch/resource/serval:BIB_0F3C39C0FBCC.P001/REF (accessed 20 Oct. 2020).
325. *Report on the Pillar One Blueprint*, *supra* n. 323, at 23-33; Danon & Chand, *supra* n. 324, at 9.
326. Danon & Chand, *supra,* n. 324, at 8-9.
327. *Report on the Pillar One Blueprint*, *supra* n. 323, at 38-48.
328. Id., at 33-37.
329. Id., at 49-61.
330. Id., at 62-65.
331. Id., at 66-68.
332. Id., at 68-69.
333. Id., at 71-99.

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New profit allocation rules (so-called Amount A) based on predetermined formulas would apply to businesses within scope. As a detailed analysis of Amount A has already been carried out by one of the authors of this contribution,[334] the manner in which these profit allocation rules would actually work (determination of the tax base[335] and reallocation[336]) will not be repeated here. Instead, the focus will be on the following issue.

The objective of Amount A, which departs from the ALP by using a formulary approach, is to reallocate part of an MNE's residual profits to user/market countries. Naturally, if the user/market countries tax an MNE's income as a result of Amount A, then one of the main challenges within the Pillar One proposal is determining which country should provide relief for Amount A.Given that, under the existing international tax rules, the profits of a MNE are allocated among various jurisdictions on the basis of the ALP, the new profit allocation rules under Amount A would likely result in double taxation. Therefore, it is essential to put in place appropriate mechanisms to eliminate such double taxation by building on the existing mechanisms, such as tax exemptions or tax credits, or corresponding TP adjustments, and ensuring that those mechanisms continue to operate effectively and as intended.[337]

However, the application of the above-mentioned mechanisms is not straightforward, as the calculation of Amount A applies to the profits of an MNE group (or business line) as a whole, rather than on an individual entity and individual country basis.[338]This is due to the fact that Pillar One moves away from the transactional view or separate approach embedded in the ALP (in which the identification of the source and residence jurisdiction allows the application of the existing mechanisms to grant relief from double taxation), and adopts an overall profit or group approach that makes it difficult to identify the jurisdiction that should provide the relief, i.e. the jurisdiction that should surrender its taxing rights in favour of the market country.For this reason, it may not be possible to use a corresponding adjustment approach (similar to the provisions in article 9(2) of the OECD Model or UN Model) to eliminate double taxation.[339]

Therefore, one of the key issues to be solved in order to effectively implement Pillar One is to identify the jurisdiction(s) of taxpayer(s) within an MNE that will have the obligation to provide relief, by identifying the entity or entities of the MNE that will bear the Amount A tax liability and, if those entities are in more than one jurisdiction, also to determine the amount of relief to be provided by each of them in the various jurisdictions.[340]

6.3.2. The authors' perspective: Key DEMPE functions and surrender jurisdiction

According to the Statement on the Two-Pillar Approach by the Inclusive Framework on BEPS, one way to tackle this problem would be to take account of where the profits reallocated under Amount A are allocated under the existing system based on the ALP.[341]

Building on this, with respect to the identification of the entities that should provide relief from double taxation, an approach based on functions, assets and risks (i.e. the location of key decision-makers, including the location of key DEMPE decision makers) might serve as a useful instrument to solve this issue. If the deemed residual profits under Amount A are realized only by one entity within the MNE group (e.g. centralized principal or centralized IP owner), the issue can be relatively simple to solve, as such entity will carry out the key DEMPE functions (among other functions).[342]

However, if the deemed residual profits in an MNE group are distributed worldwide among different entities, this could become challenging.[343] For example, if, within an MNE group, there are multiples entities resident in different jurisdictions performing non-routine activities, and which therefore would be entitled to a portion of the deemed residual profit, identifying these taxpayers and quantifying the relief that each of them should provide could be extremely complex.

Indeed, a rigorous examination of the functions, assets and risks (including DEMPE activities) can lead to the identification of the key contributors within a MNE that should be entitled to the residual profit,[344] or better, to the deemed residual profits for the purpose of the determination of the part of profits that should be reallocated to market jurisdictions under Amount A in the Pillar One proposal.

For example,[345] assume that MNE Group X provides online streaming services through a digital platform. Company H, the parent company of MNE Group X, acting as a headquarters and resident in Country H,

334. V. Chand, A. Turina & L. Ballivet, *Profit Allocation within MNEs in Light of the Ongoing Digital Debate on Pillar I – A 2020 Compromise?*, 12 World Tax J. 3 (2020), Journal Articles & Papers IBFD.
335. *Report on the Pillar One Blueprint*, *supra* n. 323, at 100-122.
336. Id., at 123-138.
337. OECD, *Secretariat Proposal*, *supra* n. 300, at 18.
338. OECD/G20, *Statement on the Two-Pillar Approach*, *supra* n. 322, at p.15.
339. Id., at p.15.
340. Id.
341. Id.
342. H. Förster, S. Greil & A. Hilse, *Taxing the Digital Economy – The OECD Secretariat's New Transfer Pricing A-B-C and Alternative Courses of Action*, 27 Intl. Transfer Pricing J. 1, sec. 2.31 (2020), Journal Articles & Papers IBFD.
343. Id.
344. Vallat, *supra* n. 230, at 14.
345. Example inspired by (i) example 1 in the annex to chapter VI of OECD/G20, *Actions 8-10 Final Reports*, *supra* n. 3, including examples to illustrate the guidance on intangibles; and (ii) Chand, *supra* n. 283.

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has developed technology-related intangibles in connection with the digital platform through significant R&D functions performed by its own personnel. It is the practice of MNE Group X to consolidate all the intangibles (trade and marketing intangibles) in Company S, resident in Country S, in order to simplify their administration (e.g. management of copyrights internationally). Company S does not conduct or control any R&D activities, has no technical R&D personnel and does not bear any expenses in relation to the R&D activities. Company S has only limited personnel and functionality to perform copyright registration and maintenance. The assignment/transfer of the intangibles between Company H and Company S is legally executed through a written contract. It is assumed that the assignment/transfer of the intangibles is made for a nominal consideration not reflecting an arm's length compensation. Company S then licenses the intangibles back to Company H in return for royalties.

Company H employs the intangibles in its operations and derives business income from remote sales of online streaming services from two countries. Firstly, from Country D, where MNE Group X has a marketing services subsidiary, viz. Company D. Essentially, Company D consults Company H for the development of a strategic and marketing plan, and Company H takes the final decisions regarding the advertising, the budget and the positioning in the local market. Secondly, from Country E, where MNE Group X does not have a taxable presence under existing rules (e.g. no subsidiary or branch regarded as a PE). Company D also assists Company H in this market by contacting and coordinating with independent marketing and advertisement service providers. For its services, Company D receives an arm's length service fee-based compensation from Company H for the marketing expenditures that it incurs. The transactional net margin method is used. Thus, Company D bears a limited risk in relation to its sales activity. The sales in Countries D and E surpass the nexus threshold to be subject to the rules under Amount A of the Pillar One proposal.

In the event that an Amount A tax liability arises in countries D and E for MNE Group X, the questions arise of which company should bear the Amount A tax liability, and which jurisdiction should provide relief from the taxation suffered in these market countries. Would it be (i) Company S, the legal owner of the intangibles, and Country S; or (ii) Company D, the entity that assists in the execution of the marketing plan, and Country D; or (iii) Company H, as the company performing most of the functions in relation to the intangibles, and Country H? A key functional analysis (including DEMPE analysis), based on the true nature of the arrangement and the conduct of the parties, may provide a solution. In this case, the analysis of the functions, assets and risks may lead to the result that Company H is the entity performing and/or controlling almost all the key functions in relation to the intangibles developed to provide the online services. As Company H in Country H is entitled to the non-routine profits, being the one performing the key controlling DEMPE functions, it should be the entity bearing Amount A tax liability and Country H should provide relief from double taxation.

Now assume a second scenario in which the functionality of Company S is different. For instance, Company S hires senior software developers. These developers, firstly, oversee the acquisition of all intangibles from Company H on an arm's length basis. Secondly, these developers, in conjunction with the developers of Company H, develop "enhanced" intangibles to improve the digital platform's performance and outreach. Essentially, key DEMPE functions are performed by both entities. All intangibles are legally owned by Company S. Company S licenses the intangibles back to Company H in return for arm's length royalties. The arm's length compensation is determined by applying the profit split method. Under the second scenario, one can conclude that both entities contribute to the key DEMPE functions and, therefore, that they should be entitled to a portion of the deemed residual profits from the activity of MNE Group X. As a result, Company S and Company H should bear Amount A tax liability (probably a priority rule will need to be introduced), and Country H and Country S should provide relief from double taxation.

Obviously the above examples are a simplification, and in practice the use of functional analysis (including the DEMPE approach) to identify the entities that have to provide tax relief and the allocation of the amount of the tax relief is much more complicated, due to the following:

- within an MNE there might be many intangibles, whose key DEMPE functions might be managed by multiple entities. Therefore, even the application of a DEMPE method based on a VCA and/or a RA(S)CI model would be difficult to apply;
- as described in sections 5.1.1. and 5.1.2., there is a lot of uncertainty in the application of the DEMPE approach on the part of MNEs and a high degree of subjectivity in the assessment of transactions involving intangibles on the part of tax administrations. Therefore, before considering the use of DEMPE functions as a method of granting relief from double taxation under Amount A of the Pillar One proposal, the OECD and tax administrations should provide guidance and clarification on the application of the DEMPE method; and
- a solution based on the analysis of the functions, assets and risks in relation to intangibles is to some extent at odds with the formulaic nature of Amount A.Indeed, the general tendency seems to

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be towards a more formulaic approach instead of a facts and circumstances-driven analysis.[346]

Accordingly, in addition to the functional analysis (including DEMPE analysis), other indicators will need to be developed to identify the paying entity and surrender jurisdiction. The Report on the Pillar One Blueprint, correctly, moves in this direction. The report states that identification of the entity or the entities that will bear the Amount A tax liability (the paying entity or entities), and hence the jurisdiction(s) in which they are resident and that will be required to relieve the double taxation arising from Amount A, will be based on a four-step approach,[347] as follows:

(1) an *activities test*, which allows identifying the entity or entities within a group or segment that performs activities that make material and sustained contributions to an MNE group's ability to generate residual profits;
(2) a *profitability test*, which ensures that the entities identified under the activities test have the capacity to bear the Amount A tax liability;
(3) a *market connection priority test*, which ensures that the Amount A tax liability for a market jurisdiction is allocated to a paying entity that is connected to a market jurisdiction through the performance of activities identified under the activities test; and
(4) a *pro-rata allocation*, in case the entity or (entities) identified under the market connection priority test do not have sufficient profits to bear the full Amount A tax liability for a given market jurisdiction.

Consider the following examples of the application of the four indicators. The first deals with a centralized structure. Thus, consider the situation of MNE R, which is in the business of making and selling branded clothes. It has its ultimate parent, viz. Company R in Country R. Company R operates as a centralized principal entity. This entity also owns the trade and marketing-related intangibles that it has developed. The company sells its clothes, which are produced in Country R, in 20 different markets. The clothes are sold through related low-risk distributors. If an Amount A tax liability arises in the 20 different markets, then it is clear that Company R could be identified as the relevant taxpayer. In fact, in the *activities test*, the identification of the paying entities that contributed to the generation of the residual profits is based on an analysis that takes into account whether an entity has performed core strategic and operational activities by having decision-making authority over key aspects of those activities. In particular, the Report on the Pillar One Blueprint clearly mentions that entities performing some of or all the DEMPE functions in relation to valuable intangible assets of the MNE that are specific to the MNE's market engagement could be treated as paying entities for the purpose of the activities test. The documentation already submitted by an MNE (Master File, Local File or even the CbC report) can be the basis for applying this test.[348]

At the same time, in this example, the *profitability test* would be applied at the level of Company R. The test is based on a formula that leads to the deduction of a deemed routine return from the profits of Company R, in order to understand whether it books residual returns. The approach is somewhat similar to the formulaic substance-based carve-out based on payroll and tangible assets (discussed in section 6.2.2.) contemplated in the Pillar Two proposal.[349]

Of course, several issues arise when multiple entities within an MNE group make substantial contributions/perform substantial activities and could be considered to be the owner of non-routine or deemed residual profits. For example, consider the situation of Company R in Country R, which has developed all intangibles. Company R sells its products in the Country R market. Further, for its overseas operations, Company R establishes a centralized business model (Company P – a principal entity) in Country P. Company P employs the intangibles for its operations and derives business income on a remote basis from several countries (including Country S) and pays an arm's length amount of royalties to Company R. If an Amount A tax liability arises in Country S for the MNE group under Amount A, then the question arises as to who the taxpayer is to whom the tax liability could be attributed – i.e. is it Company R or Company P? In this case, as Company P is engaged with the Country S market, it should be considered, at least to begin with, the relevant taxpayer. This is exactly the outcome that is contemplated under the *market connection priority test*.[350]

On the other hand, when Company P cannot bear the entire Amount A liability, then both entities (which are characterized as entrepreneurs for transfer pricing purposes) could be identified as the relevant taxpayers. This would imply that both Country R (Company R) and Country P (Company P) could provide relief. The relief could be divided in a predetermined proportion. This outcome is contemplated in the *pro-rata allocation* test.[351]

While the above examples deal with centralized models, the analysis may become even more complicated when dealing with a fully decentralized MNE.

346. Verlinden, De Baets & Parmessar, *supra* n. 203, at 1056.
347. *Report on the Pillar One Blueprint*, *supra* n. 323, at 139-152.
348. Id., at 144-147.
349. Id., at 147-149.
350. Id., at 148-151.
351. Id., at 151-152.

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For example, consider the situation of MNE P, which is headquartered in Country P through Company P. That entity owns all trade/marketing intangibles of the group with respect to Product X. Company P sets up a licensed manufacturer or a fully-fledged distributor (Company R) in Country R, to which all intangibles are licensed. Company R makes and buys and sells products in Country R. Company R pays an arm's-length royalty to Company P. If a tax liability arises for MNE P under Amount A in Country R, then, by applying the above tests, at least to begin with, the relevant taxpayer would be Company R, as it sells in the Country R market. However, if the entity is a loss-making entity, then the relevant taxpayer could be Company P.

Indeed, all the illustrations presented above seem straightforward. However, in practice, determining the paying entities could be a challenge, especially in cases in which there are multifunctional entities that carry out both routine and non-routine activities. Simplification should be explored in this area, perhaps by developing quantitative tests.

7. Key Recommendations

Undoubtedly, the OECD Guidelines (2017) will generate tax uncertainty for taxpayers. Thus, in order to promote tax certainty, the present authors propose the following.

While the use of qualitative/quantitative VCA or RA(S)CI methods can be considered, these tools lead to highly subjective outcomes that are prone to being disputed. Thus, the authors' only recommendation to taxpayers (and especially to large MNEs prone to tax audits around the globe) is that they should use their time, money and resources to make use of cooperative compliance programmes or bilateral or multilateral APAs. This would be the case when taxpayers are operating with either centralized or decentralized structures.

On the other hand, the authors have several recommendations for policymakers. First, in line with the conclusion in section 3.3.2.1., the OECD should explicitly state that concepts such as "control over risk", "financial capacity" and " DEMPE" are clarificatory concepts. Such a statement could be included perhaps within the OECD Guidelines themselves.

Second, additional work needs to be done with respect to the commercial rationality exception discussed in section 3.3.2.2. An analysis of that exception in light of the Canadian case law indicates that domestic TP rules may permit only a narrow application of this exception. As a result, the OECD should conduct a survey of national TP rules and, if the survey indicates that the rules apply narrowly (or do not apply at all), then the OECD should propose an amendment of national rules in order to obtain coherence in this area. The advantage of obtaining coherence is to ensure that tax administrations invoke TP rules as opposed to national GAARs when dealing with commercially irrational structures or transactions. As an alternative or an add-on, this test could be codified in article 9. This approach would be similar to the approach adopted vis-à-vis the guiding principle, which was codified in the OECD Model (2017) as the principal purpose test. Moreover, an analysis of that exception, especially, in the context of intangibles indicates that classifying an arrangement as commercially irrational is highly complex. Additionally, the borderline between applying this exception and accurately delineating the transaction is quite thin (at least, as understood by the guidance issued by the Dutch and Australian tax administration). In this regard, more examples will need to be provided to clarify the application of this exception and address the borderline.

Third, additional guidance is needed vis-à-vis the role of a funder, as discussed in section 4. The authors suggest that guidance should be provided as to when an investment is high risk or not so high risk, as, depending on the answer, the returns on funding could vary significantly. In fact, the higher the risk, the higher the return should be for the funder (assuming it controls the funding and has the financial capacity to do so). As a result, depending on the situation, residual profits from exploiting the intangible could be allocated to the funder. The guidance used in the AOA on returns on capital can be used as a foundation for developing new commentary.

Fourth, in light of the discussions in sections 3. and 4., and taking into account the high risk of disputes between tax administrations and MNEs, the introduction of predetermined margins should be considered in relation to intangible transactions, in particular, low-risk R&D and low-risk funding perhaps by broadening the scope of Amount B within the digitalization debate. Fixed but flexible predetermined margins could be recommended based on the ALP. This would provide more certainty to taxpayers and reduce the overall administrative/compliance burden. As an alternate to fixed rules, safe harbours could be considered. However, the application of safe harbour rules should be considered on a bilateral or multilateral basis, so as to ensure that these rules would not create problems of double taxation or double non-taxation.

Fifth, with respect to Pillar One of the digital debate, a detailed functional analysis (including the DEMPE analysis) can serve as a useful indicator (or starting point) in identifying the entities/jurisdictions that should provide relief from double taxation for a tax liability under Amount A. However, due to several issues associated with the concept, the use of other indicators to correctly identify the paying entity and the surrender jurisdiction is also recommended. In fact, it seems that the OECD is moving in this direction. That said,

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simplification needs to be explored in this area, perhaps by resorting to quantitative tests.

Finally, Pillar Two clearly goes beyond profit allocation under the key ALP (including DEMPE functions) concept. As discussed in section 6.2.2., the authors would like to state only that a balance needs to be struck between the aim of combating tax competition and achieving an administrable system for both taxpayers and tax administrations. Thus, as a final decision on these parameters has not yet been confirmed, the authors prefer the adoption of a global blending approach with no carve-outs (and no carve-out for a return on tangible assets), as it represents a simpler system, in which compliance costs would be lower for both MNEs and tax administrations. Alas, recent developments indicate that jurisdictional blending with formulaic substance-based carve-out will be the way forward.

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