Abstract

Multinational enterprises (MNEs) operating by way of wholly owned subsidiaries are responsible for an increasing percentage of global trade. This paper looks at how the existing rules based on the arm's length principle allocate a MNE’s profit between the taxing jurisdictions in which it operates. It highlights the limitations of the arm's length principle by reference to a centralised intangible asset model and prior academic literature. This paper then examines in greater detail how the arm's length principle deals with MNE economic rent. The paper looks at the sources of economic rent in general, and then examines in detail the impact on economic rent of operating as a MNE by way of controlled subsidiaries rather than through independent or uncontrolled entities. The paper then examines the impact of the recent work done by the OECD on Base Erosion and Profit Shifting (BEPS) and reviews the recent Australian court decision of Chevron Australia Holdings Pty Limited v. Commissioner of Taxation [2015] FCA 1092, proposing that the approach taken by the court in this case can be extended to allow the existing arm's length principle to more appropriately allocate MNE economic rent to taxing jurisdictions.

Keywords: arm’s length principle, transfer pricing, MNE economic rent, BEPS

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Mind the gap – the arm’s length principle and MNE value creation

1. Introduction

A large majority of trade\(^1\) is undertaken by MNEs operating by way of wholly owned corporate groups. For income tax purposes the global profit of a MNE needs to be allocated to each of the taxing jurisdictions in which it operates so each jurisdiction can apply its own corporate tax to that allocated profit. The international standard which OECD and UN member countries use to determine this allocation is the arm’s length principle.\(^2\) For MNEs that operate as a corporate group with subsidiary companies\(^3\) this principle treats each of the subsidiaries of the MNE as if it were a separate independent party and seeks to establish a transfer price for each transaction entered into between these separate legal entities. The arm’s length principle is long-standing but in recent years, the principle, and transfer pricing rules in general, have come under increasing scrutiny by revenue agencies, scholars and other commentators, most recently as part of the OECD’s Base Erosion and Profit Shifting (BEPS) agenda.\(^4\)

A particular challenge for the arm’s length principle and current transfer pricing rules is posed by the centralised intangible asset model that is widely adopted by global MNEs. This operating model essentially centralises the MNEs legal ownership of intangible assets, often in the tax jurisdiction of the MNE’s ultimate holding company, while transferring the rights to exploit the intangible assets in all countries, other than the home country, to a low tax jurisdiction. The operating subsidiaries of the MNE, including the research and development operations, manufacturing and distribution entities, are set up to perform limited functions and take on limited risks. This paper focuses on the problems that arise in applying the arm’s length principle to this model of MNE operation. It pays particular attention to MNE economic rents (which will be defined) derived through the use of this

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\(^2\) OECD (2010, 22 July) and United Nations Model Double Tax Convention 2011), Article 9.

\(^3\) This paper focuses on the impact of transfer pricing on separate legal entities and does not consider the impact of operating by way of permanent establishments.

\(^4\) Transfer pricing is mainly considered in Actions 8-10 of the BEPS agenda, OECD (2015a), herein referred to as the “2015 Guidelines”. 
model. The paper then looks to analyse the impact of recent developments internationally and in Australia on addressing this issue. In particular, this paper examines the likely effect of the agreed OECD BEPS Actions\(^5\) and Australia’s existing and new transfer pricing laws, including the approach of the Australian Federal Court in the Chevron\(^6\) case on these issues. Finally, the paper addresses other approaches to the arm’s length principle that could be applied.

Section 2 explains the centralised intangible asset model commonly used by MNEs to structure their global operations.\(^7\) The section also provides an overview of the arm’s length principle and performs an analysis of how these principles apply to the model in the first instance, without reference to the safeguards that have been put in place to protect the arm’s length principle, which are addressed in Section 3.

Section 3 surveys the academic literature which has identified the limitations of the existing application of the arm’s length principle and explains these limitations by reference to the centralised intangible asset model presented in Section 2. The main limitations identified are (i) recognition of related party contracts (ii) inadequacy of comparable data (iii) lack of consideration of MNE economic rent and (iv) difficulties in determining an arm’s length price for sale of intangible assets. This section also identifies the safeguards that have been put in place to protect against some of the limitations. The safeguards identified are (i) pricing the substance of the transactions (ii) reconstruction of the intra-group transactions (iii) dealing with hard to value intangibles (iv) use of profit split method and (v) consideration of MNE group synergies.

While all of the limitations identified in Section 3 affect the outcome of an application of the arm’s length principle, this paper then focuses in more detail in Section 4 on the elements that contribute to MNE economic rent and economic rent in general. This section draws on economic theory of economic rent and also on the theory of the firm.\(^8\)

In brief, MNE economic rent is defined in this paper as the profit or economic return that MNEs have access to, over and above a “normal” market rate of return, because they

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\(^5\) OECD (2015c)
\(^6\) “Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (no 4)” 2015
\(^7\) The structure given is referenced to the electronic consumer goods industry, but the focus of this paper is not necessarily limited to this industry. It is important to each industry has particular considerations and an area for future research would be to take the analysis presented in this paper and consider it in light of various industry circumstances.
\(^8\) Coase (1937)
operate globally through 100 per cent (wholly) owned legal entities. As pointed out by the existing literature identifying the limitations of the arm’s length principle, the economic rent derived by MNEs from their global corporate structure managed by control is largely missed in the application of the arm’s length principle. This is because the arm’s length principle treats a MNE as if it is a collection of independent entities and thereby ignores the reality that a portion of a MNE’s economic return is created because it is a collection of entities managed by control, rather than by external independent contracts.

To date, the majority of commentary has focused on this MNE economic rent being driven by intangible assets and has therefore focused on the challenges of setting transfer prices for intangible assets in a MNE. While acknowledging the importance of intangible assets, this paper addresses the question slightly differently, first, by identifying factors such as a MNE’s large size, vertically integrated operations, global value chain, ability to invest in and protect intangible assets and operating across multiple market places, all of which allow a MNE to create MNE economic rent; and, second, connecting this with the characteristics of intangible assets that allow MNEs greater access over other kinds of business models to developing, enhancing, maintaining, protecting and exploiting intangible assets. This paper argues that it is only by considering the impact of both of these questions that we can understand the full extent of MNE economic rent.

Section 5 reviews how the identified elements of MNE economic rent are treated under the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“2010 Guidelines”) and identifies the way in which these Guidelines, including the safeguards, do not fully address MNE economic rent. It then proceeds to address the impact of the recent OECD BEPS work on both MNE economic rent and the original set of limitations and safeguards of the arm’s length principle. This section concludes with an analysis of where there are still some practical and conceptual gaps between the limitations of the arm’s length principle and the safeguards.

Section 6 reviews the academic solutions proposed to overcome the gaps. These fall into three categories being first, replacement of the arm’s length principle with a global formulary apportionment approach; second, the adoption of a modified profit split method and third an extension or modified application of the arm’s length principle. The author

9 OECD (2010, 22 July)
10 OECD (2015c)
considers the last approach to be the most promising and this section outlines further adjustments which could be made to modify the arm’s length principle to overcome the existing limitations, especially for the treatment of MNE economic rent. This section also considers the current support for such an approach, the impact of the Chevron\textsuperscript{11} decision and most importantly how the approach may be applied practically. Finally, the impact of Australia’s new transfer pricing law is also considered.

2. Overview of how MNEs operate and transfer pricing principles

A MNE has the ability to determine the functional, asset, legal and risk profile of its separate legal entities because all of its subsidiaries are 100 per cent owned and therefore not subject to normal market place negotiations. A number of factors (which are outside the scope of this working paper) have resulted in MNEs generally operating using a centralised intangible asset model.\textsuperscript{12}

In order to facilitate analysis of how the transfer pricing principles apply, this section presents a simplified example of how a MNE in the consumer technology goods industry may utilise a centralised intangible asset model. It also provides an explanation of the relevant transfer pricing principles that have been developed to analyse the intercompany transactions that occur and a high level analysis of how the 2010 Guidelines\textsuperscript{13} apply to the model.\textsuperscript{14}

\textsuperscript{11} “Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (no 4)” 2015
\textsuperscript{12} For a general discussion of the factors that have contributed to this see OECD (2013)
\textsuperscript{13} OECD (2010, 22 July)
\textsuperscript{14} The model and analysis presented have been done in a simplified way in order to facilitate analysis and provide clarity for the issues to be discussed. MNE use a variety of structures some of which are variations on the centralised intangible asset model as presented, others which have different elements. Some points to note are: (i) it is assumed that none of the legal entities have Permanent Establishments in foreign jurisdictions (ii) the intercompany flows are as stated in the model. There is a variety of ways the intra-group transactions can be structured. In the author’s experience, the transactions presented are transaction flows which are the most common. However, it is recognised that they represent a simplification of the often complex workings of a MNE (iii) the transfer pricing analysis has assumed an absence of comparable transactions. This may not always be the case. However, in the author’s experience good quality comparable transactional information is very rarely available. (iv) the transfer pricing analysis has been performed at a very high level and has assumed a simplified fact pattern. In reality, a detailed analysis is required of the facts and circumstances of each MNE group and the intra-group transactions it enters into. However, for the purposes of illustrating the allocation issues that arise, the simplified model draws out the major points (v) the intangible asset owner with the rights to exploit the intangible assets either globally, or for the rest of the world outside HQ’s jurisdiction, is represented as being in a low tax jurisdiction. Generally, there will be a number of entities and transaction flows around the intangible asset rights. These structures are focused on lowering the corporate and withholding tax incidence on any income allocated to the intangible asset owner, therefore providing the incentive to maximise this income allocation utilising transfer pricing. As the tax structuring elements (including the application of Controlled Foreign Corporation provisions) are not the focus of this...
The analysis performed in this section is a ‘prima facie’ application of the arm’s length principle without reference to whether any of the arm’s length safeguards would be enlivened to overcome any or all of the limitations of the arm’s length principle identified in the model. In particular, this initial analysis prices the legal form intra-group transactions and does not consider whether the legal form equates to the substance of the transactions. It should also be noted that given the limitations in availability and comparability of independent party data and transactions, determining the most appropriate transfer pricing method is often an iterative process [as outlined by the 2010 Guidelines and is dependent on the relative judgment between data availability and reliability compared to consideration of the most appropriate transfer pricing method based on conceptual considerations. In order to illustrate the limitations of the arm’s length principle when applied to the centralised intangible asset model, the assumption in the following analysis is that independent party comparable data is not available or sufficiently comparable. This assumption is a simplification of how the arm’s length principle may be applied in practice where interpretation of data is performed taking into account the balance of accuracy in the comparable data and application of the most appropriate method. In practice pragmatic use of data is often pursued in order to retain use of the most appropriate method. However, this required judgement in and of itself illustrates both a conceptual and practical limitation of the arm’s length principle.

2.1 Centralised intangible asset model

The main elements of a centralised intangible asset model for the consumer technology goods industry are depicted in the chart at Figure 1.

Figure 1: Centralised intangible asset model of a MNE

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paper, for simplicity, just the one entity is shown as receiving the income from the exploitation of the intangible asset. (vi) the impact of intra-group funding has not been included.

15 OECD (2010, 22 July)

16 Thoughts and comments provided by Michael Jenkins, Assistant Commissioner, Economist Practice, Australian Taxation Office February 2016.
In this model, the Head Quarter (HQ) originator of the product formulation, associated brand name and intangible assets is usually in a high tax country, for example the United States of America (US).

At some point the separately identifiable intangible assets (or the rights to exploit them) such as brand name, trademarks, patent and production technology have been transferred to a low tax environment, represented by Intangible Asset Owner. The transfer normally takes place either as a sale of the intangible assets from HQ to Intangible Asset Owner or as shared ownership under a Development Cost Contribution Arrangement, or both. Development Cost Contribution Arrangements provide for the joint development and ownership (or rights to exploit) any of the resulting intangible assets. The intangible asset ownership generally takes the form of HQ retaining the full legal ownership of the intangible asset plus the rights to exploit the intangible asset in the jurisdiction in which it operates, with Intangible Asset Owner entitled to the rights to exploit the intangible assets for all other worldwide jurisdictions. Where one party contributes existing intangible assets at the beginning of the Cost Contribution Arrangement, as HQ has done in this model, if the

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17 This can be either an overall low tax jurisdiction, or a high tax jurisdiction which provides concessional tax treatment for various types of income (for example patent box regimes) or time periods (for example tax concessions for periods of 5 or 10 years for MNEs that locate operations in particular regions).

18 Refer to Ting (2014), page 44 for a description of how Apple Inc.’s Cost Contribution Arrangement operates.
joining party, in this instance Intangible Asset Owner, does not contribute a similar value of assets, they will need to make a ‘buy-in’ payment to compensate for the existing intangible assets contributed by HQ.

Intangible Asset Owner, as the new owner of the rights to exploit the intangible assets in all non HQ jurisdictions (for example in all jurisdictions other than the US) then contracts with wholly owned subsidiaries\(^\text{19}\) of the MNE to perform various functions including ongoing research and development, manufacturing, marketing strategy and distribution of the good. Another subsidiary normally performs a regional hub role, for example in the Asia Pacific region. This includes performing a strategy role for the region, logistics planning and various management activities such as accounting, legal and human resource functions. The regional hub normally purchases the finished good from the Intangible Asset Owner and sells these goods to local subsidiaries in each of the consumer markets that have been tasked with executing local marketing activities and importing and distributing the final product.

The MNE has control over all of the terms and conditions of the contracts entered into between it and its subsidiaries, and between those subsidiaries. In general, the contracts are structured to give each of the ‘operational’ subsidiaries, i.e. the entities performing the research and development, manufacturing, regional hub and marketing and distribution functions, as little functional responsibility as possible, including limiting the amount of risk the operational subsidiaries take on.

In the case of the research and development contract with the R&D Subsidiary, the Intangible Asset Owner will provide all research and development funding and bear the costs of any activities which fail to produce intangible assets as an outcome of research and development. Intangible Asset Owner will also bear all the costs and risks associated with product liability claims. The entity contracted to perform the research and development activities, will be guaranteed to earn a profit on all its activities, generally calculated based on cost plus a mark-up.

In the case of the manufacturing contract, the Manufacturer subsidiary will manufacture to order using production technology provided by the Intangible Asset Owner. The Manufacturing subsidiary will therefore bear no raw material or finished good inventory risk

\(^{19}\) Legal ownership of the subsidiaries may be by the Intangible Asset Owner, HQ or some other wholly owned entity within the group.
nor own or develop any manufacturing intangible assets. The Marketer/Distributor subsidiary (herein referred to as the Distributor subsidiary) will generally only order and take delivery of the finished goods if there is an end customer order. Therefore, the Distributor will not bear any inventory risk either. Any product liability risk will normally be assigned to the Intangible Asset Owner by means of the terms of its related party manufacturing and distribution contracts. Any accounts receivable risk will most likely be contractually shifted to the Regional Hub.

2.2 Overview of transfer pricing principles

The arm’s length principle is the international standard used to allocate a MNE’s profit to the tax jurisdictions in which it operates. This principle treats each of the entities in a MNE as if it was a separate independent party and establishes transfer prices for each transaction entered into between these separate legal entities\textsuperscript{20}. The OECD has developed extensive guidelines which expand on how the arm’s length principle is to be applied in practice. Since their introduction in 1979, these guidelines have undergone various stages of revision with the most recent consolidated version published on 22 July 2010.\textsuperscript{21} The 2010 version of the guidelines has most recently been impacted by the issuance of the final OECD BEPS reports.\textsuperscript{22}

Central to the arm’s length principle is the requirement to compare a related party transaction (i.e. a transaction between the separate legal entities within a MNE) to independent party transactions to determine whether the transactions are similar enough to provide an arm’s length price. The 2010 Guidelines\textsuperscript{23} outline five comparability factors to perform this analysis:

1. **characteristics of property or services:** this relates to the elements of the good or service that is being transacted;

\textsuperscript{20} The arm’s length principle is stated in paragraph 1 of Article 9 of the OECD Model Tax Convention and provides “[Where] conditions are made or imposed between the 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”.\textsuperscript{21} OECD (2010, 22 July){\textsuperscript{22} There are 13 final OECD BEPS reports which were released on 5 October 2015. The most relevant ones for the purposes of this analysis are Actions 1 ((OECD, 2015 #95@@author-year)), 5 (OECD (2015b)), and 8 to 10 (OECD (2015a)). These will be addressed in Section 5 of the paper.\textsuperscript{23} OECD (2010, 22 July), para 1.36
2. **functional analysis**: an analysis of the economically significant activities undertaken by the parties, or put another way, the MNE value chain. The functions performed, assets used and risks borne as part of the value chain are analysed. Assets encompass both tangible and intangible assets;

3. **contractual terms**: the terms of the relevant transaction, for example, payment terms, currency etc.;

4. **economic circumstances**: this requires an analysis of the markets in which the transactions take place and includes consideration of the regulatory environment, the relative competitive positions of the entities etc.; and

5. **business strategies**: the impact of business strategies such as market penetration, degree of diversification etc. need to be considered.

In applying the arm’s length principle, it would be expected in general that the more functions performed, assets owned and risks borne by a particular entity in relation to a transaction, the more profit would accrue to that legal entity in respect of that transaction. The other factors set out above, including the characteristics of the property or services that are the subject of the transaction, contractual terms, economic circumstances and business strategies will also influence the allocation of profit between each of the parties to the transaction.

There are five transfer pricing methods set out in the 2010 Guidelines. These include three traditional transaction methods: comparable uncontrolled price (CUP); resale price and cost plus and two transactional profit methods: transaction net margin method (TNMM) and transactional profit split method.

The CUP method compares the price charged for property or services transferred in a related party transaction to the price charged in a comparable uncontrolled transaction in comparable circumstances. The resale price and cost plus methods apply the gross margin earned (in the case of resale price) or charged (in the case of cost plus) in comparable independent party transactions to related party transactions. These methods apply at the transaction level, for example, the price paid for the imported good by the

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24 OECD (2010, 22 July)
25 OECD (2010, 22 July) paragraph 2.13
marketer/distributor subsidiary, or the resale margin\textsuperscript{26} earned by the marketer/distributor subsidiary on the sale of each good distributed.

Both the TNMM and profit split methods apply at the net profit level for the relevant set of aggregated transactions. Where an entity performs similar transactions across its whole operations the methods will apply at the whole of entity level. This would occur, for example, where the only function of the entity was the wholesale distribution of a range of products in the same industry. Where an entity performs functions in different industries or in different ways, the methods will most likely apply to each of the separate business units. This would occur, for example, if an entity performed both manufacturing and wholesale distribution functions.

The TNMM compares the net operating profit\textsuperscript{27} of the legal entity in a MNE that undertakes international related party transactions and is being analysed for transfer pricing purposes to the net operating profit earned by comparable entities operating independently with similar functional profiles to the MNE subsidiary in comparable circumstances. For example, a financial ratio such as net operating profit to sales may be applied to compare the net operating profit of the MNE subsidiary with that of a comparable independent entity.

The profit split method considers the overall profit made in respect of the sale of the products or services in a particular tax jurisdiction by the MNE. There are two variations of the profit split method. The \textit{contribution method} allocates the overall profit to each of the controlled subsidiaries in the group that have contributed to the generation of the profit. The allocation is based on a reasonable approximation of the division of profits which independent parties would have expected to realise from engaging in comparable transactions.\textsuperscript{28} The other approach is the \textit{residual method}. The residual profit split method approach first allocates a return to the routine, or non-unique, contributions made by each entity, usually using the TNMM to do so. Second, any residual profit is then allocated

\textsuperscript{26}That is, the difference between the net sales proceeds and the cost of goods sold
\textsuperscript{27}Net operating profit is normally measured as Revenue less Cost of Goods Sold less Selling, General and Administration expenses. It excludes tax and may exclude financing costs. It also aims to measure the normal operating profit of the aggregation of transactions and may therefore exclude non-operating or non-recurring items such as large scale one-off redundancy costs.
\textsuperscript{28}OECD (2010, 22 July), paragraph 2.119
between the controlled entities in a way which should replicate an arm’s length division of the profits. 29

2.3 Application of transfer pricing principles to centralised intangible asset model

The task of transfer pricing is to determine an arm’s length price for international related party transactions of a legal entity. In the centralised intangible asset model outlined above, the legal form of the intra-group transactions are:

- the sale price of the Intangible Asset from HQ to Intangible Asset owner, or amount of the buy-in payment under a Cost Contribution Arrangement (sale of intangible asset);
- the performance of research and development services by R&D subsidiary for Intangible Asset Owner;
- the purchase of manufactured goods by Intangible Asset Owner from Manufacturer (finished good transaction);
- the purchase of the goods by Regional Hub, including the right to on-sell the goods using the brand name and the sale of these goods, with associated rights, to the Distributor subsidiary (finished good transaction, or possibly finished goods plus payment of a royalty); 30
- the provision of management services (including accounting, legal and human resource services) by Regional Hub to Manufacturer and Distributor (service transaction); and
- the purchase of goods by Distributor from Regional Hub.

The question now becomes how do the transfer pricing methods apply to these legal form intra-group transactions? Noting there are various safeguards, which are examined in Section 3 that may alter the prima facie application of the transfer pricing methods.

2.3.1 Is there a comparable uncontrolled price?

In order to apply the CUP method, comparable uncontrolled transactions in comparable circumstances need to be identified. This is unlikely to be the case in the centralised intangible asset model illustrated above as generally a MNE distributes a unique product and is unlikely to use independent parties to manufacture or distribute its product.

29 OECD (2010, 22 July), paragraph 2.132
30 In order to simplify the analysis it is assumed that a separate royalty is not charged.
In relation to the sale of the intangible asset or the buy-in payment as part of the Cost Contribution Arrangement, it is unlikely that the intangible asset has previously been acquired from or sold to an independent party. As such, the CUP method is unlikely to be available. In respect of the sale of the finished goods in some instances comparable transactions may be available and the CUP method can be used, however for most MNEs the only independent party transaction which occurs in respect of the good is the sale to an independent retailer or end customer. These transactions do not provide comparable prices as it is not in comparable circumstances, i.e. they are at the retail or end consumer level, rather than at the manufacturing or wholesaling level, which is where the transactions occur in the related party example. Further, the services provided by the Contract R&D subsidiary and the Regional Hub are also unique and it is unlikely CUPs would be available for these transactions either.

2.3.2 What about resale price or cost plus methods?

The resale price and cost plus methods rely on information being available about an independent party gross margin (i.e. net sales less cost of goods sold) to enable comparison with the subject transactions. However, reliable independent party gross margin information is rarely available from publicly available sources. While financial statements of independent manufacturers and wholesale/distributors may be available, it is difficult to analyse these accounts at the gross margin level with any level of accuracy. This is due to a variety of factors including first: publicly available accounts are normally released at a consolidated level, meaning the financial performance of various business units performing variable functions are combined and second: it is almost impossible to determine which expenses have been classified as cost of goods sold (and included in the gross margin calculation) versus selling, general and administrative expenses (which are not included in the gross margin calculation).

Therefore, these methods are generally only available where the controlled party, or another member in the MNE group, has undertaken independent party transactions at this level. In the above example this would involve manufacturing similar products for an independent party or marketing/distributing similar independent party products. Within the confines of a MNE this very rarely occurs. Even if independent party transactions have occurred they would still need to be in sufficiently comparable circumstances to allow their use for the application of these methods. In practice, while these methods are sometimes available, for a vast majority of cases they are not used.
2.3.3 Profit split method

The 2010 Guidelines\(^{31}\) aim to apply the profit split method to circumstances where either the operations of the MNE are highly integrated or where two or more separate legal entities in a MNE group make significant unique contributions to generate the profit. The profit split method would “ordinarily not be used in cases where only one party to the transaction performs only simple functions and does not make any significant unique contribution (e.g. contract manufacturing or contract service activities in relevant circumstances)".\(^{32}\) In the centralised intangible asset model set out above, the MNE has been able to structure its operations so that prima facie the manufacturing and distribution functions conducted by the individual subsidiaries are limited in nature, with the likely consequence that the profit split method is not applicable to these operations. Similarly, the majority of the functions performed by the Regional Hub are logistics and management services which, even if strategic in relation to a region, are unlikely to be considered as providing a ‘significant unique contribution’ to the MNE profit.

The MNE has also been able to structure the performance of its research and development activities as the provision of limited risk contract research and development services by R&D subsidiary. Any risk associated with the research and development is borne by Intangible Asset Owner and any unique assets generated from the research are owned by Intangible Asset Owner.

In sum, the way functions, assets and risks have been allocated throughout the group by the MNE mean the global value chain is fragmented and as such is not prima facie nor traditionally treated as being highly integrated. Second only, Intangible Asset Owner legally or prima facie owns unique assets or makes significant unique contributions. Therefore, the profit split method would not be appropriate.

It is also unlikely that the profit split method would apply to assist in determining the price for the sale of the intangible asset or the buy-in payment. This is because at the date of transfer, or entering into the cost contribution arrangement, it is unlikely that parties other than HQ would have contributed to the development of the intangible asset. Further, the profit split method is more generally used to allocate ongoing income from the exploitation of an intangible asset, rather than assisting in determining an arm’s length price for a sale.

\(^{31}\) OECD (2010, 22 July), paragraph 2.109

\(^{32}\) OECD (2010, 22 July), paragraph 2.109
of an intangible asset at a particular time. However, the profit split method may be utilised as part of a valuation technique used to determine the value of the sale of the intangible asset or the buy-in payment. This is discussed in more detail below.

2.3.4 Transaction net margin method (TNMM)

As explained above, in relation to the centralised intangible asset model of MNE operation, it is likely that none of the transactional CUP, resale price or cost plus methods, or the profit split method can be applied to determine arm’s length prices for the intra-group transactions. In consequence, the TNMM is the only remaining option.

The TNMM will operate in this example by searching for independent parties in comparable circumstances with comparable functional profiles to the MNE entities. This will result in the need to perform four separate comparable searches. These searches would be for independent entities that perform:

- research and development services in the same country as R&D subsidiary;
- manufacturing functions in the same country as Manufacturer;
- strategic marketing, logistics and management services in the same country as Regional Hub; and
- marketing and distribution functions in the same country as Distributor.

Ideally, these searches will result in the sourcing of comparable data where the comparables have similar level of functions (often represented by the level of expenses incurred), hold similar level of assets (in this case, no intangible assets) and bear similar risk levels (in this case limited risks).

The MNE will apply the TNMM to each of the operating subsidiaries and practically, this will mean each of the R&D, Manufacturing, Regional Hub and Distributor entities’ related party transactions will be priced so as to target a net operating margin. For the R&D and Manufacturing subsidiaries, this net operating margin is likely to be determined as a net operating profit to total expenses margin, while for the Regional Hub and Distributor, it is likely to be a net operating profit to sales margin. All the transactions that take place within the MNE group between these entities will be reflected in this margin.\(^{33}\) The overall logic is that if the net operating margin for each entity equates to what an independent party in

\(^{33}\) Depending on the operating model, separate charges may be put in place for the provision of intra-group services. However, if the TNMM is used, the net impact is the same for the operating subsidiary, regardless of whether a separate charge is made for the services or not.
comparable circumstances earns then all the intra-group transactions must be occurring at an arm’s length price.

Therefore, the manufacturing entity will sell the good to the Intangible Asset Owner for a price which is calculated in order to earn the target net operating margin for the Manufacturer. The Distributor will import the good for a price from the Regional Hub for a price which is designed to do the same. The price of the good will vary throughout the period depending on the costs incurred by each of the operating subsidiaries and the ultimate sales price to the first independent party, normally the retailer.

2.3.5 Sale of intangible asset or buy-in payment

For the sale of the intangible asset or the buy-in payment it is unlikely that any of these transfer pricing methods outlined above will be directly applicable. The practical solution in this regard has been to perform a valuation of the intangible asset with the aim of determining an arm’s length price for it. Although this price will not represent a CUP unless there has been a third party acquisition or sale, it will enable an approximation of what the arm’s length price should be. As part of the valuation a discounted cash flow analysis of the intangible asset will often be performed. In order to estimate the anticipated cash flow from exploitation of the intangible asset other transfer pricing methods may also need to be used, for example, the TNMM or the profit split method.

2.4 Summary: application of transfer pricing methods to the MNE centralised intangible asset model

The overall impact of the prima facie application of the transfer pricing methods set out above to the centralised intangible asset model is that the Intangible Asset Owner will be allocated all of the profit generated by the sale of consumer technology goods outside of HQ’s home jurisdiction, for example the US, except for the net margin that is retained by the limited risk operational entities for performance of their functions of contract research and development, contract manufacturing and limited risk marketing/distribution. Therefore most, if not all, of the profit of a MNE over and above the return for these limited risk functions will be allocated to the Intangible Asset Owner. As noted by Vann the above
model has allowed MNEs “to take a substantial operation in a source country and effectively dismantle and reconstruct it in such a way that virtually no profits are left there.”

This prima facie application of the arm’s length principle to the centralised intangible asset model is illustrated in the chart at Figure 2. The example assumes a good is sold to an end customer for $1,000, the Distributor and Regional Hub entities have a net operating target of 5 percent operation profit to sales and that the Manufacturer receives a cost plus 10 percent fee and the R&D entity receives a fee based on cost plus 20 percent.

As illustrated, the Intangible Asset Owner is allocated $233 profit, or 66 percent, of the total profit of $350 derived by the MNE group from the sale of the $1,000 good. In the prima facie application of the arm’s length principle, whether this is the appropriate return to the Intangible Asset Owner is not tested. Rather, it is purely the residual amount after allocating a net operating margin to each of the operational subsidiaries.

3. Limitations and safeguards of the Arm’s Length Principle

Commentary on the limitations of the arm’s length principle has been long standing with increased scrutiny in more recent years due to the BEPS agenda. Significant contributions

34 (Vann, 2003), p. 157
have been made by Avi Yonah\textsuperscript{35}, Clausing\textsuperscript{36}, Durst\textsuperscript{37}, Harvey\textsuperscript{38}, Kadet\textsuperscript{39}, Langbein\textsuperscript{40}, Li\textsuperscript{41}, Schon\textsuperscript{42} and Vann\textsuperscript{43}. This section examines three major limitations identified in the literature, specifically recognition of related party contracts within the MNE as the starting point for analysis; the lack and inadequacy of available comparable data; and the identification and price of intangible assets. A fourth major limitation, the failure to properly account for MNE economic rent, is addressed in Section 4.

This section also examines the safeguards that have been put in place to mitigate some of these limitations. The safeguards identified are (i) pricing the substance of the transactions (ii) reconstruction of the intra-group transaction(s) (iii) dealing with hard to value intangible assets (iv) use of profit split method (including guidelines on ownership of intangible assets) and (v) consideration of MNE group synergies. This section provides a brief overview of these safeguards and considers both the practical and conceptual inadequacies of these safeguards as they exist in the 2010 Guidelines.

As you would expect, the safeguards, in general, align with the identified limitations and each limitation and associated safeguard are addressed together. As such, the safeguards relating to MNE economic rent are dealt with in Section 4. In some instances one safeguard will address more than one limitation and there are some areas that have specific commentary but which fall within an overall safeguard. These interactions are shown in the following table.

\textsuperscript{36}Clausing and Avi-Yonah (2007)
\textsuperscript{37}Durst (2013), Durst (2011)
\textsuperscript{38}Harvey Jr. (2013)
\textsuperscript{39}Kadet (2015)
\textsuperscript{40}Langbein (1986), Langbein (1990) and Langbein (2005)
\textsuperscript{41}Li (2002) and (Li, 2012)
\textsuperscript{42}Schon (2010) and Schon (2014)
\textsuperscript{43}Vann (2010), Vann (2003) and Vann (2014)
### Table 1: Limitations and safeguards of the arm’s length principle

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### 3.1 Limitation 1: Recognition of related party contracts

#### 3.1.1 Limitation 1.1: Separation of functions, assets and risks

The ability to manage by control means MNEs have limited commercial reasons to negotiate written contracts for dealings between their related entities. However, related party contracts are required for tax and regulatory purposes as a starting point to analyse and price the related party dealings that have occurred. While there may also be other legal requirements for contract preparation it is largely for tax purposes that such written intra-group contracts are put in place. The problem is that unless there is a legal or specific tax requirement to make the terms of the contract equivalent to what arm’s length parties would have agreed, a MNE can draft the terms of the contract however it likes. By this means, MNEs can determine the allocation of functions, assets and risks among group
entities by way of intra-group legal agreements. The impact of this, as stated by Vann, is “freedom of contract thus often means that profit allocation is a matter of choice for firms.”

This problem is more pronounced for factors which are easily moveable such as intangible assets and risks. Core functions requiring personnel and physical assets may be difficult to move to different legal entities or jurisdictions by means of a contract. However, intangible assets and risks have no physical presence and therefore can be more easily moved from one legal entity (and tax jurisdiction) to another by amending the terms of intra-group contracts.

In the centralised intangible asset model, the intra-group contracts provide that the risks associated with performing all of the development, enhancement, maintenance, protection and exploitation activities are allocated to the Intangible Asset Owner, even though the functions are performed by each of the operational entities (being the R&D service provider, the Contract Manufacturer, the Regional Hub and the Marketer/Distributor subsidiary). This allocation of risk also allows for the prima facie ownership of all intangible assets to be assigned to the Intangible Asset Owner.

Thus, prima facie recognition of intra-group contracts can allow the MNE to separate functions from intangible asset ownership and risks from functions. There are also two specific areas which have facilitated and encouraged this separation of functions from risk and asset ownership: (1) cost contribution arrangements; and (2) patent box regimes. These are explained in more detail below.

3.1.2 Limitation 1.2: Development cost contribution arrangements

A development cost contribution arrangement allows for the costs of development and the ownership (or rights to exploit) the resulting intangible assets to be shared by each participant to the agreement. MNEs, especially US MNEs, have often used these arrangements to retain the legal ownership of the intangible asset in the US HQ entity, but shift the rights to exploit the intangible assets in all jurisdictions other than the US, to an entity in a low tax jurisdiction.

This is illustrated in the centralised intangible asset model above. HQ has used such an arrangement to move the right to exploit the intangible assets in all non-HQ countries to

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44 Vann (2010), p. 323 and also more generally Vann (2003) for a detailed discussion of this issue. See also IMF (2014), p. 32
Intangible Asset Owner that is resident in a low tax jurisdiction. Any new research and development will be jointly funded by the cost contribution arrangement participants, i.e. HQ and Intangible Asset Owner. Because functions and ownership can be separated, the research and development function can be outsourced, either to a related party in HQ country or another jurisdiction. The costs of the outsourced research and development will be borne by all parties to the arrangement, generally in proportion to the sales generated from the intangible assets. The entity performing the research and development functions will generally be rewarded with a cost plus fee, with its appropriateness tested using the TNMM. The risk of failure and any product liability risks will be borne by the participants to the cost contribution arrangement.

While the Intangible Asset Owner will have to purchase its share of the existing intangible asset rights contributed at the beginning of the cost contribution arrangement, any rights associated with newly developed intangible assets for the non-US jurisdictions will be owned by the Intangible Asset Owner, who is generally located in a low tax jurisdiction. These arrangements have often been very effective as the existing intangible assets can be contributed to the cost contribution arrangement prior to significant commercialisation and therefore their valuation has been relatively low or highly uncertain (refer to section 3.5 on the issues associated with valuing intangible assets). This has allowed minimal tax to be paid on the transfer of the asset into the arrangement.

3.1.3 Limitation 1.3: Patent box regimes

Patent box regimes provide low tax rates for income generated from the exploitation of intangible assets owned or developed in the particular country. Most patent box regimes have historically allowed outsourcing of the actual research and development, therefore also respecting the separation of functions and intangible asset ownership.

3.2 Safeguard 1: Pricing the substance of the transaction

3.2.1 Safeguard 1.1: Substance in general

While the starting position of the 2010 Guidelines is that a MNE’s transfer pricing “should be based on the transaction actually undertaken by the associated enterprises as it has been

45 Refer Harvey Jr. (2013) and Ting (2014) for commentary on the impact of cost contribution arrangements used by Apple Inc.
46 PWC (2013)
structured by them”47 and that “MNEs are free to organise their business operations as they see fit”48, the 2010 Guidelines do provide for intra-group contracts to be ignored in two exceptional circumstances.49 The first is where economic substance does not equate to legal form.

As explained in Section 3.1.1 and illustrated by the centralised intangible asset model, central to the issue is the ability of a MNE to allocate risk. The 2010 Guidelines commentary on risk notes, on the one hand, that functions will to some extent determine the allocation of risk between parties and that a party will generally only take on risk if it has the financial capacity to do so and if it can control the risk. The concept of control is discussed to mean the ability of the entity to make the relevant decisions relating to the risk51 including such things as the decision to hire a contract researcher, the decision of the type of research that should be carried out etc.

On the other hand, the 2010 Guidelines allow that it is not necessary to perform the day-to-day monitoring and administrative functions in order to control a risk52 and they also provide examples of contract manufacturer and contract research accepting in these arrangements that no meaningful risk is taken on and implying that risk can be shifted by contract.53 Further, the guidance on business restructurings reinforces the view that the starting point for the analysis of risk is an “examination of the contractual terms between the parties”54 although there is the accompanying proviso of consistency with economic substance.

These principles are illustrated by an example in the 2010 Guidelines55 where a manufacturer sells goods to a related party distributor allocating all foreign currency risk associated with those transactions to the distributor. In contrast, in comparable independent party transactions the manufacturers bear all the currency risk. The 2010

47 OECD (2010, 22 July), paragraph 1.64
48 OECD (2010, 22 July), paragraph 9.163
49 OECD (2010, 22 July), paragraph 1.64 to 1.69
50 OECD (2010, 22 July), paragraphs 1.45 to 1.51 and 9.22 to 9.38
51 OECD (2010, 22 July), paragraph 9.23
52 (OECD, 2010, 22 July), paragraph 9.24
53 Contract research and development arrangements are again referred to in Chapter VI of the 2010 Guidelines where in paragraph 6.3 it is noted that “the developer may perform the research activity…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.”
54 OECD (2010, 22 July), paragraph 9.11
55 OECD (2010, 22 July), paragraph 1.69
Guidelines conclude\textsuperscript{56} that while the lack of independent party transactions where the distributor bears the currency risk may indicate the transaction should be examined more closely, this does not necessarily mean the tax administration should disregard the intra-group transaction. The allocation of risk to the distributor should only be disregarded if “there is good reason to doubt the economic substance of the controlled distributor’s assumption of [the] currency risk.”\textsuperscript{57}

One of the issues with this approach is that ultimately, MNEs have control over the allocation of functions, assets and risks. As is seen in the discussion of the MNE centralised intangible asset model above, the Intangible Asset Owner will likely be the entity that provides research and development funding to the Contract R&D subsidiary. As such, the Intangible Asset Owner will bear the risk. In respect of the Contract Manufacturer and Distributor, these entities will not hold large stocks of raw material or inventory on their balance sheets as processes will be put in place such that raw material and finished goods will not be purchased until guaranteed orders from Intangible Asset Owner or end customers are placed.

Further, the concept of control as explained by the 2010 Guidelines refers to the ability to make the important decisions in respect of risk. Arguably, it takes very few people to make these decisions and as long as they are employed by the Intangible Asset Owner, the control threshold is met. Therefore, the economic substance will reflect the legal allocation of risk.

Finally, in order for a revenue agency to assert the economic substance is not in line with the legal form, often it will be necessary to gather a large amount of information. Moreover, apart from those tax jurisdictions in which research and development activities take place, the benefit for a revenue agency from asserting economic substance is not equivalent to legal form will probably be marginal. This is because, unless the local entity is developing intangible assets, it is unlikely that any additional profit will ultimately be allocated to them. I return to this issue in Section 4, when discussing MNE economic rent. It is also interesting to note that in a review of transfer pricing cases in the period between 2000 and 2010 in the UK, US, Canada and Australia Roin\textsuperscript{58} found that “the courts gave full effect to the

\textsuperscript{56} (OECD, 2010, 22 July)
\textsuperscript{57} OECD (2010, 22 July), paragraph 1.69
\textsuperscript{58} Roin (2012), p.238
taxpayers’ division of ownership and responsibility between entities.” However, as explored in Section 6, there are some recent court decisions which have focused more on the evidence regarding the commercial implications of the legal form and have resulted in the courts looking more to the substance of the arrangements when pricing the intra-group transaction and in this respect evidence of the actual financial and commercial conditions of the related parties is paramount.  

3.3.2 Safeguard 1.2: Cost Contribution Arrangements
The 2010 Guidelines contain Chapter VIII dealing with Cost Contribution Arrangements. The commentary provides that “in some cases, the facts and circumstances may indicate that the reality of the arrangement differs from the terms purportedly agreed by the participants.” and then reverts to the general commentary about substance in paragraphs 1.64 to 1.69 of the 2010 Guidelines as explained above. Paragraph 8.30 also provides that there may be instances where a tax administration may disregard part or all of the CCA “where over time there has been a substantial discrepancy between a participant’s proportionate share of contributions…and its proportionate share of expected benefits, and the commercial reality is that the participant bearing a disproportionately high share of the contributions should be entitled to a greater beneficial interest in the subject of the CCA”. In general, however, this is not a concern for MNEs as there is benefit in ensuring that the entity in the low tax jurisdiction funds as much and receives as much of the resulting ownership/beneficial interest as possible.

The final safeguard in paragraph 8.30 is a general statement allowing for a tax administration to “disregard the CCA in its entirety” in “circumstances that indicate an attempt to abuse the rules governing CCAs”. As noted in Section 3.2.1, unless the tax jurisdiction is performing research and development activities or is the tax jurisdiction that contributed intangible assets to the CCA, the impetus to take on the evidentiary burden to disregard the CCA can be marginal. This is also linked to the current limitations associated with identification of intangible assets and MNE economic rent and will be explored further in Section 4 and 5 below.

59 Comments provided by Mr Michael Jenkins, Assistant Commissioner of the Australian Taxation Office, February 2016 referencing “Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (no 4)” 2015).
60 OECD (2010, 22 July)
61 OECD (2010, 22 July), paragraph 8.29
3.2.3 Safeguard 1.3: Patent Box Regimes

There is no specific guidance in the 2010 Guidelines around patent box regimes.

3.3 Safeguard 2: Reconstruction

As noted above, while the starting position of the 2010 Guidelines is that a MNE’s transfer pricing is based on the legal form intra-group transactions, two exceptional circumstances override this starting premise, the first is substance as explained in section 3.2 and the second is where the arrangements, in their totality, differ from those which would have been entered into by independent parties and they practically impede a determination of an appropriate arm’s length price. In this instance, the 2010 Guidelines provide that “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 transacting at arm’s length.”

The preconditions that need to be met before it is considered appropriate for a tax administration to restructure the MNE’s intra-group transactions are therefore that the circumstances need to be exceptional and that the transaction practically impedes a determination of an appropriate arm’s length price. These preconditions, combined with the judicial preference for starting with the legal form transaction and the practical evidentiary difficulties associated with proving what independent parties would have done in comparable circumstances mean that from the author’s practical experience, tax authorities have not sought to enliven the reconstruction safeguard in many instances.

3.4 Limitation 2: Inadequacy of comparable data

The second major limitation in applying the arm’s length principle is the lack of comparable data. There are two main issues with comparable data. First, if the most efficient way to compete in an industry is by operating as a MNE, then ultimately all independent competitors would have been driven out of the market with the market being made up purely of MNEs. Therefore, by definition, no independent party comparable data will exist. In the author’s experience this is borne out in practice and echoed by comments made by Deputy Commissioner of the Australian Taxation Office, Mr Mark Konza, in his testimony at

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62 OECD (2010, 22 July), paragraph 1.64 to 1.69
63 Reference 2010 OECD paragraph 1.66
64 It also should be noted that reconstruction of intra-group transactions may not necessarily be provided for in a local jurisdiction’s transfer pricing provisions depending on how they are drafted.
the recent Senate Inquiry when he noted “I think it is fair to say there is limited room to move in these transfer pricing guidelines. The guidelines will help us in extreme examples, but I do not know that that is going to help us. The problem with transfer pricing really is that it is difficult to find comparable transactions. Comparable transactions often tend to drag profitability down to lower levels, because in the pharmaceutical industry, for example, independent operators are usually doing generic drugs, so it is a low-fuss operation; they happen to be the only comparables you have that you can use in patented situations, so that drags the average down.”66 What this testimony is implying is that in the pharmaceutical industry the most profitable way to distribute patented drugs is via related parties, therefore there are no (or limited) independent party comparables that are distributing patented drugs. Rather, the only independent distributors are of generic drugs and while they are not very good comparables as they are distributing a different category of product, i.e. generic drugs rather than patented drugs, because they are the only comparables available this is what is used.

The second issue is the level of publicly available financial information. In general, where a comparable entity has been identified, the level of financial information publicly available is limited and does not allow for detailed analysis of the entity’s functional or financial profile. For example, levels of marketing spend are rarely separately disclosed, rather this would be included in general operating expenses. Even if it is a separate line item in the profit and loss account often it is shown at a global, rather than by country level and the ability to analyse it is restricted as there is not likely to be sufficient accompanying detail of the exact nature of the expense. Further, financial accounts that are available publicly are consolidated, meaning numerous operating subsidiaries and business lines are included with no separate details being provided.

A result is that the ultimate application of the arm’s length principle using the TNMM is often based on a very broad set of comparable data where the industry and functional comparability is tenuous. Kadet notes the application of the arm’s length standard “normally only provide[s] highly subjective ranges of acceptable pricing...[allowing MNEs]...to set pricing within the subjectively determined ranges that further skew profits into low or zero-tax countries.”67

66 Hansard (2015), p. 56
67 Kadet (2015), page 1184
The 2010 Guidelines, while recognising that sourcing comparable data may be difficult, tends to ignore this practical impediment and in the section on comparability suggests analysis and adjustments which are virtually impossible based on publicly available information.\footnote{OECD (2010, 22 July), paragraphs 3.38 and 3.47} The only time when such detailed analysis may be viable is where the MNE has entered into a comparable independent party transaction and therefore holds more financial and functional information.

3.5 Limitation 3: Identification and price of intangible assets

The third major limitation in applying the arm’s length principle concerns how to identify and price intangible assets. As outlined in Section 3.1 the respect for intra-group legal contracts has facilitated centralisation of intangible asset ownership and shifting of intangible assets to low tax jurisdictions. This has two impacts. First, where intangible assets have originally been owned in high tax jurisdictions, the intangible asset, or at least the right to exploit it, may be shifted to a low tax legal entity requiring valuation of the asset at the time of transfer. The second impact of centralised intangible asset ownership is that the starting point of the analysis prima facie allows for the intangible asset owner to derive all residual profit associated with the exploitation of the asset. The safeguard to counter this, being the application of the profit split method, is only enlivened if the entity is considered to be highly integrated or there is joint contribution or ownership of intangible assets, thus making identifying the intangible assets critical. These two areas are explored in more detail below, along with the associated safeguards. It is also important to note that in extreme cases, the substance and reconstruction safeguards may also be applied to counter the abovementioned limitations of the arm’s length principle.

3.5.1 Limitation 3.1: Value highly uncertain

Where an intangible asset has originally been developed in a high tax jurisdiction, as illustrated by the centralised intangible asset model, there is benefit in transferring this asset, or at least the rights to exploit it, to a low tax jurisdiction. This transfer is either done by way of sale or as a contribution to a cost contribution arrangement rewarded by a buy-in payment. If the sale price or buy-in payment is appropriate then the sale or contribution of the asset is taxed in the home jurisdiction and value accumulated up unto that point would be subject to an appropriate level of tax. However, often an intangible asset is transferred prior to significant commercialisation and/or its value is highly uncertain. This makes the
task of determining an appropriate arm’s length price for the intangible asset very difficult. This is compounded by the 2010 Guidelines requirement that intangible assets be separately identifiable before recognition of their value is allowed, explained in more detail below.

3.5.2 Limitation 3.2: Separately identifiable intangible assets

Respect of the intra-group sale contract means that a MNE can structure a transaction so that only separately identifiable intangible assets are transferred as opposed to transferring the ongoing business associated with the intangible asset. In the context of the centralised intangible asset model, HQ can transfer the brand name, manufacturing process and technology associated with the technology good. The items that are transferred will be separately valued, probably using a form of a discounted cash flow analysis. There are a number of reasons why this type of approach can significantly undervalue the intangible assets. First, goodwill is often specified as not being transferred, so value that the entity makes from culture, for example, is not included. Second, the valuation will be based on various assumptions. Such assumptions often include that the intangible assets will not be further developed, i.e. it values the assets as at the date of transfer, rather than considering the potential value of the intangibles as a potential buyer would. Third, it does not take into account the profit generated by the intangible asset because it is used by the MNE, in conjunction with other assets such as culture, as opposed to isolated use by an independent party.

A narrow approach to the definition of intangible assets was taken in Veritas Software\(^69\) where the judges restricted the intangible asset as the lines of computer code in the software having the effect that when the code was replaced, the underlying code was deemed to have no future value.\(^70\) This approach not only ignored the usefulness of the software code as a platform for the next generation of product, it also ignored any interaction value the software had with other intangible assets of the business.

Since the centralised intangible asset model will result in all residual profit being allocated to the new Intangible Asset Owner, the new owner of the separately identifiable intangible assets will also reap all the reward for the non-separately identifiable intangible assets which have been effectively transferred to the new Intangible Asset Owner tax free.

\(^69\) “Veritas Software Corp v. Commissioner” 2009
3.6 Safeguard 3: Hard to Value Intangible Assets

The 2010 Guidelines\(^{71}\) provide some commentary around how to deal with uncertain value at the time of the transaction. The overriding criterion is to consider “what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.”\(^{72}\) Some of the possible options include considering the net present value of anticipated benefits, adopting shorter-term agreements, allowance for price adjustments and agreeing to renegotiation if fundamental assumptions are impacted by major unforeseen developments. However, the 2010 Guidelines also recognise the difficulty in auditing such arrangements especially since such audits often occur several years after the transfer.

The 2010 Guidelines provide no specific commentary in relation to goodwill. Further, while they recognise that intangibles can be hard to value, as noted above, there are no specific solutions provided.

3.7 Safeguard 4: Profit Split Method

As outlined in Section 2.3.3, where the profit split method is applied, the overall profit derived by the MNE in respect of the manufacture and sale of products in a particular market is captured and split between all members in the group which contribute to the generation of the profit. Therefore, where the profit split method is applied it is more likely each contributing party will be allocated a portion of residual or non-routine profit.

The 2010 Guidelines\(^{73}\) aim to apply the profit split method to circumstances where either the operations of the MNE are highly integrated or where two or more separate legal entities in a MNE group make significant unique contributions to generate the profit. As such, the profit split method will not be applied unless it can be illustrated that the MNE operations are highly integrated or there is joint ownership or contribution to intangible assets. Chapter VI of the 2010 Guidelines provides guidance in respect of special

\(^{71}\) OECD (2010, 22 July), pp. 191-203
\(^{71}\) OECD (2010, 22 July), paragraph 6.6
\(^{71}\) OECD (2010, 22 July), paragraph 2.109
\(^{73}\) OECD (2010, 22 July), paragraph 6.6
\(^{72}\) OECD (2010, 22 July), paragraph 2.109
considerations for intangible property. The overall implication from the chapter is that intangible assets need to be identified with specificity and in particular “care should be taken in determining whether or when a trade or marketing intangible exists”. Further, in respect of marketing intangibles, the message is that unless a distributor has a long-term sole distribution agreement, it is unlikely to enter into expenditure which will create a marketing intangible as it would have no guarantee of being able to exploit the intangible asset in the future. Examples are given where marketing expenditure is reimbursed by the intangible asset owner ensuring that all intangible asset ownership is retained by that party. The overall result is that there is a general acceptance of the centralised intangible asset model allowing MNEs to structure their operations so that operational subsidiaries do not trigger intangible asset ownership.

4. MNE economic rent

As outlined in Section 3 one of the major limitations of the arm’s length principle is that it fails to properly account for MNE economic rent. This section focuses in more detail on what MNE economic rent is and considers the impact of the theory of the firm, the impact of size and the characteristics of intangible assets on a MNE’s access to economic rent. It also reviews academic literature in the area and analyses the treatment of MNE economic rent by the 2010 Guidelines.

4.1 What is MNE economic rent?

For the purposes of this analysis, what is important to identify is profits that are generated or increased purely because the MNE operates by means of a group of commonly controlled legal entities as opposed to a group of independently owned entities. This increased return will be referred to generally in this paper as MNE economic rent.

The term ‘economic rent’, although long-standing in the economic literature is notoriously difficult to define. There are two starting definitions. The first, defined by the followers of Ricardo, is the excess amount earned by a resource over the sum necessary to induce the

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\(^{74}\) OECD (2010, 22 July), pp. 191-20

\(^{75}\) OECD (2010, 22 July)
factor to be used. The second is the Pareto definition: economic rent is the excess between a resource's returns in its best and second best use. The former definition is the one which is used most generally.

There is also much debate around whether economic rent can be sustained in the long term. Johnson notes "supernormal returns can survive for decades, perhaps centuries, because of entry barriers and first-mover advantages". However, Schoemaker notes there are varying views as to whether long-term or even short-term economic rents are attainable. Even though there are these differing views, it is fair to note that the main sources of economic rent, if it exists, are considered to be barriers to market entry (whether through regulation or some other means); scarcity of resources (in the context of the modern day MNE these are often intangible assets) and the complexity, information asymmetry and uncertainty which exist in the real-world market place, including the element of luck.

In this section, the author aims to assess whether a MNE has greater access to these three elements because it operates as a MNE rather than as a group of independent entities.

To address this question, the following sections will look first look to the characteristics of a MNE. Then, due to the importance of intangible assets as the main source of scarce resources (leaving natural resources aside), the characteristics of intangible assets will be reviewed to assess whether MNEs also have greater access to these assets over independent entities. The following sections will then address the impact of these characteristics on the ability of MNEs to access and sustain economic rent and additionally whether some economic rent is generated purely because the MNE operates by way of a group of commonly controlled legal entities as opposed to a group of independently owned entities.

4.2 Characteristics of a MNE

This section considers what economic and management theory has contributed to the understanding of why MNEs exist and how MNEs create value and thereby generate economic rent.

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77 Wessel (1967), p. 1179 and 1222
78 Wessel (1967), p. 1179 and 1222
80 Wessel (1967), p. 1180
81 Including monopoly and oligopoly power
82 Schoemaker (1990), Dierickx and Cool (1989) and Barney (1986)
economic rent. Key contributions concern the theory of the firm and the impact of a MNEs size.

4.2.1 Theory of the firm

A large body of work has been devoted to trying to understand why MNEs exist and the boundaries of the international firm. Coase’s original theory of the firm explained that a firm exists if the price of individual transactions in an independent market is more costly than controlling the factors of production in one entity. Yeaple extends this to an international context and explains that “multinational firms exist when the common ownership of productive facilities across international borders is more efficient than market transactions are.” It follows that a MNE will have lower transaction costs than independent parties operating through third parties or independent agents across jurisdictions. These costs span a number of areas including searching for partners, negotiating contract terms, information exchange, monitoring and contract enforcement and dispute resolution.

The internalisation of transactions will also reduce the costs associated with limited information as more information is held internally. This means MNEs will have more information available at a lower cost than entities operating in a market by way of independent party contracts. Given the increased importance of information in the modern economy this asymmetry is becoming increasingly more valuable. This increased access to information also allows MNEs to more easily access structural market imperfections and may also provide increased ability to identify and therefore deal with uncertainty.

The impact of developing, enhancing, maintaining, protecting and exploiting intangible assets within a wholly-owned MNE, rather than performing some or all of these functions by way of independent party contract, also has a large impact on intangible assets. Vann notes that “the theory of the firm often emphasises asset specificity as one of the reasons

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83 Coase (1937)
84 Yeaple (2013), p.195
85 Theory of the firm Coase (1937); Cecchini, Leitch, and Strobel (2013), p. 33
87 Think of, for example, internet data collected which increases the ability to sell advertising.
88 Cecchini et al. (2013)
for the formation of the firm and the capturing of profits on the assets which are not possible in normal market transactions.\(^{89}\)

One impact of operating as a MNE is the level of investment in intangible assets.\(^{90}\) Intangible assets have many features of a public good\(^{91}\) including that consumption by one user will not reduce the assets availability to another user. This characteristic can result in investment “hold-up”.\(^{92}\) This problem occurs when an initial investor invests in an intangible asset and then transacts with an independent second investor. When negotiating the transaction price, the second investor will try and extract some of the initial investor’s return in the price paid. Anticipating this, the first investor will initially under-invest and the second party can potentially “hold-up” the level of initial investment. The hold-up problem means it is unlikely a consortium of independent parties will invest in intangible assets to the extent a MNE will. The hold-up issue extends across all levels of intangible asset investment but has a significant impact on the more inseparable intangible assets such as human resources, culture and external relationship building.

The second impact on intangible assets is the higher risk of intangible asset dissipation that independent entities bear.\(^{93}\) In order for an independent party to exploit its intangible assets in another jurisdiction it will need to provide some detail of its intangible assets to third parties. This opens up the risk the third party may steal the intellectual property. It has been shown that MNEs are more likely to operate in industries in which there is less patent protection, or where patent protection is not readily enforceable.\(^{94}\) Operating via a third party also brings the risk the third party may harm the reputation of the brand, for example, by providing poor service associated with the intangible asset. A MNE is not exposed to the former risk and while it is still exposed to reputational risk from its foreign affiliates, it has greater ability to control this risk and take remedial action if required.\(^{95}\)

\(^{89}\) Vann (2010), p.332. See also Langbein (1990), p. 5
\(^{90}\) Graetz and Doud (2013)
\(^{91}\) N. B. Johnson (2006)
\(^{92}\) Cecchini et al. (2013), p. 40
\(^{93}\) Yeaple (2013), p. 210-211 provides a summary of the work done exploring asset dissipation. The timing of contracting with independent parties varies across industry and long life-cycle industries in which patent protections are weak are less likely to contract with independent parties. As noted by Yeaple, this work supports the “idea that asset dissipation is a serious concern” for MNEs.
\(^{94}\) Avi-Yonah (1995-1996), page 1342-1343
\(^{95}\) Yeaple (2013), p. 210
Another implication of operating as a MNE is that a MNE has the ability to make decisions which may benefit one legal entity, or group of entities, within the group but disadvantage others. For example, a MNE may benefit from entering a new market through a subsidiary entity, even though it does not have a competitive advantage in this market and so that subsidiary entity may make economic losses in the short or even long term. The benefit of entering and maintaining operations through a loss-making entity in a new market may come from a variety of sources including achieving production economies of scale, enhancing its reputation as a global brand and augmenting the resource and knowledge base of the MNE as a whole. If the entity were operating through independent entities it would have to incentivise the entity to participate in the market and this may involve higher transaction costs. As such, this implication is a subset of the lower transaction costs to which a MNE has access. This also has particular implications for the allocation of profit and loss across taxing jurisdictions.

A further implication of the theory of the firm concerns location savings that can be accessed by a MNE. Location savings occur when a firm is able to source production from a low cost location. While independent entities also have the ability to outsource production to low cost locations, this comes with higher costs than if a MNE outsourced production to a controlled entity. These higher costs include the transaction costs of dealing with independent parties such as sourcing suppliers, contract negotiation, maintenance and enforcement costs (including the increased difficulty in enforcing contracts across borders), cultural investment costs and the risk of intellectual property violation. Therefore, location savings are more readily available to MNEs.

Operating as a MNE may also bring with it certain costs that firms dealing with independent parties would not have. For example, increased costs may be incurred by local management in devoting time and resources to protecting the local operation’s place in the value chain, so as to ensure its functions do not become redundant to the global group. Another impact of operating as a MNE is the management of incentive structures to ensure that decisions are made by all levels of firm management which are to the benefit of the

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96 These losses will generally be quarantined to the tax jurisdiction in which they are incurred and while they may be available to be offset against future profits in that jurisdiction, they will generally not be available to be offset against current or future profits in other jurisdictions. However, tax planning may also be available to overcome any quarantining.
97 Barney and Peteraf (2014)
98 Yeaple (2013), p. 194
global group, even if they may be to the detriment of the local entity. There is a cost to devising, implementing and monitoring incentive schemes as well as the cost of the actual incentives. Those MNEs which perform this function well will retain a higher proportion of any MNE economic rent.\(^9^9\)

If there is economic rent derived by managing by control rather than by independent contracts, this return is due to the firm operating as a MNE rather than as a collection of independent parties. The areas of impact identified above include: lower transaction costs; information asymmetry; higher levels of investment in intangible assets; less risk of intangible asset dissipation; ability to determine terms of inter-group contracts, ability to make decisions that benefit the MNE as a whole, but which may cause losses in a particular market and greater access to location savings.

4.2.2 Impact of size

While it is possible for independent entities to access the benefits associated with size, it is much more likely MNEs will have access to pecuniary economies and economies of scale, scope and experience (collectively referred to as ‘economies’). From 2009 to 2015 alone, market capitalisation size required to be in the Global Top 100 companies, has more than doubled from $40b in 2009 to $85b in 2015\(^1^0^0\), indicating the increasing size of MNEs.

Pecuniary economies are cost savings resulting purely from a firm’s large size, for example, access to volume discounts. The same level of inputs produce the same level of outputs, but the inputs can be acquired at a cheaper price purely due to volume or size.\(^1^0^1\) This can be contrasted with economies of scale which occur when the output of a MNE increases by more than the change in inputs. For example, where an increase in volume produced allows for fixed or indivisible costs (such as the employment of a management employee)\(^1^0^2\) to be shared across more units therefore allowing for a decreased cost per unit.

Economies of scope occur where two products can be produced more cheaply together than if they had been produced individually. For example, the management of brands and families of brands across related markets or the sharing of technologies across similar

\(^1^0^0\) PWC (2015)
\(^1^0^1\) Haucap, Heimeshoff, Klein, Rickert, and Wey (2013)
\(^1^0^2\) McGee and Thomas (1986), p. 153
industrial processes. Economies of scope may also result in product diversification which in turn results in risk diversification if the products differ in their business cycles.

Economies of experience occur when there is a pooling of management talent on related problems. Because a MNE is more likely to have a larger number of employees working across a more diverse product range they will benefit from economies of experience. Each of these economies may be available to parties operating independently (either through expansion in one jurisdiction or by way of external contracts across jurisdictions) and therefore one could argue the impact of these economies does not fall within the definition of MNE economic rent. However, MNEs as a result of their operation across many markets through controlled entities have greater access to these economies than entities operating independently. If these economies are not considered when allocating profit across jurisdictions there is a large section of profit generated by these economies and more readily available to MNEs (as compared to independent parties) which is ignored.

4.3 Characteristics of intangible assets

Intangible assets are “non-monetary sources of probable future value generation, lacking physical substance, and attributable to the firm”. The importance of intangible assets in creating value is becoming increasingly recognized with a recent study estimating intellectual capital accounts for 45 percent of worldwide GDP, with the figure substantially higher for the US at just over 70 per cent and slightly higher for the European Union at 51 per cent. Further, the difference between MNE’s net tangible assets and market capitalisation has also increased over time, indicating the increasing importance of intangible assets which are generally not fully accounted for in a MNEs balance sheet. Intangible assets are generally classified into three broad categories: human assets, structural or infrastructure assets and relationship assets.

The resource based view of the firm provides a lens through which to assess the importance of intangible assets to a MNE. This theory views the MNE as a combination of resources and capabilities and investigates how and why particular assets and capabilities generate high levels of profit. The more scarce, durable, harder to trade and imitate these

103 {MgGee, 1986 #68@author-year}, p. 152
104 MgGee and Thomas (1986), p.152
105 (Marr, 2004a, p. 2) , p. 2
106 Stähle, Stähle, and Lin (2015)
resources and capabilities are, the higher the level of sustainable economic rent available to the MNE that owns or controls them. These resources and capabilities are accumulated over time through expenditures. The durability of these assets depends on how easily they can be imitated or whether they can be substituted. If the combination of resources and capabilities were easily tradeable, any competitive advantage associated with that combination would be competed away. The mere fact that sustainable competitive advantage exists indicates that the combination of resources and capabilities an entity holds are essentially non-tradeable other than in the sale of the whole business.

The most valuable intangible assets are not easily tradeable. Intangible assets do not necessarily need to be saleable or even separately identifiable to create value for a MNE. For example, the culture of a firm and the ability to share knowledge across the separate legal entities in a firm often using a form of ‘in-house’ language and across tax jurisdictions, may not be separately identifiable nor is it capable of being sold separately. Yet this ‘culture’ intangible can generate significant value for a MNE by allowing it to distribute its goods across markets in the most cost efficient and timely way. If we take the example of firm culture, much has been written on how to enhance firm culture, indicating that it is indeed something that creates value, even though it cannot be separably sold.

In order for the combination of the resources and capabilities to retain its competitive advantage they must also be difficult to imitate and substitute. Dierickx and Cool identified five factors that impact the extent to which a particular stock of intangible assets is non-imitable:

1. **time compression diseconomies**: doing the same thing over a longer period of time versus a shorter period will result in the creation of more value. For example, in the context of expenditure on research and development, this suggests that spending $1 million per year for 10 years will create a more valuable stock of intangible assets than spending $10 million in one year. Of

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108 Amit and Schoemaker (1993); Dierickx and Cool (1989); Cecchini et al. (2013)
110 Dierickx and Cool (1989), pp. 1504-1505
113 Dierickx and Cool (1989)
course, this is not an absolute but the empirical evidence suggests that, in general, this is the case.\textsuperscript{114}

2. \textbf{asset mass efficiencies}: occur when a high level of existing assets makes it easier to create additional assets. For example, having an existing software program and computer code may allow for more developments or leaps to occur versus starting the creation of this intangible asset from scratch.

3. \textbf{inter-connectedness of asset stocks}: occurs when the development of a new intangible asset is enhanced due to the existence and ownership of another asset. For example, distribution of an existing software program and computer code through a customer base results in a better understanding of customer’s needs and this information results in the development of an additional, completely different software solution to meet a different need.

4. \textbf{asset erosion}: the impact of asset erosion can vary depending on the circumstances. For example, if an asset decays rapidly then establishing a credible imitation is difficult as the time period is short. However, if the asset decay is longer then imitation becomes more possible.

5. \textbf{causal ambiguity}: this refers to the fact that intangible assets do not necessarily have value or create value by themselves, but rather it is the interaction of a set of intangible assets, that is the source of value creation.\textsuperscript{115} We do not yet have a clear understanding of how some intangible asset stocks are created and we certainly do not have a full understanding of how they interact to create value.\textsuperscript{116}

The combination of these factors in relation to the particular stock of a MNE’s intangible assets will influence the ability of the intangible assets to be imitated by others in the market. A number of these factors also influence the ability to build and accumulate the intangible asset stock in the first instance.

Another point worth noting is that value generated from an intangible asset also depends on the context in which it is used, the other assets it is used with and the interplay with the other tangible and intangible assets. An illustration of this is when companies take their business model, or their set of intangible assets, into another culture and then fail. For

\textsuperscript{114} Dierickx and Cool (1989) cite various empirical evidence p. 1507
\textsuperscript{115} Marr (2004b)
\textsuperscript{116} Dierickx and Cool (1989), p. 1509
example, when The Body Shop entered the US market it was nowhere near as profitable as it had been in its home UK market.\textsuperscript{117} In this situation, there had been a change in the bundle of intangible assets being used, (i.e., the employee culture was different) and the context in which the intangible assets were being used in (i.e. the customer culture). Thus, while the business model may be valuable in a certain context (i.e. in this instance the UK market) it may not be as valuable in another context (i.e. the US market) and with some of the intangible elements missing. Therefore, it is impossible to assign a standardised value to an intangible asset as the value it creates varies according to the context in which it is used.

As an extension of this point, is that as noted above, intangible assets rarely have value by themselves. Intangible assets generally need to be used with other tangible and intangible assets to have value. Kaplan and Norton\textsuperscript{118} give the example of a new growth orientated sales strategy requiring the development of a number of intangible asset elements including: knowledge of customers, training for sales employees, development of databases and information systems, a change in organisation structure, and a new incentive compensation program. The development of any one of these in isolation, or a combination of them, but not all of them, could mean the goal of sales growth would not be achieved. Therefore, in isolation the individual elements of intangible assets would either have substantially less value or be valueless.

Assuming the intangible assets are non-imitable due to the factors outlined above, the assets may still lose their ability to retain competitive advantage if a substitute renders the intangible assets obsolete by creating a completely different alternative. An obvious example is a completely new technology development, for example, the introduction of the DVD player over VHS. However, more subtle shifts can also occur as in the example given by Dierickx and Cool\textsuperscript{119} of when Canon, capitalising on its superior research and development capabilities designed more reliable copy machines which made Xerox’s extensive service network and reputation partially obsolete.

The other important element contributing to competitive advantage is scarcity. Scarcity is contributed to by the factors that make the combination of resources and capabilities non-

\textsuperscript{117} Wheelan and Hunger (1999)
\textsuperscript{118} Kaplan and Norton (2001), p. 89
\textsuperscript{119} Dierickx and Cool (1989), p. 1509
imitable. Regulatory environments are also important. In some instances regulatory protection is vital in order to retain an intangible asset’s ability to be scarce. This is the case in all industries for protection of brand names etc. and it plays a very important role in the pharmaceutical industry in the form of patent protection for discovered or developed drugs where patent protection has allowed pharmaceutical companies to create and retain significant monopoly rent.\textsuperscript{120}

In summary, important characteristics of intangible assets include that they are not readily tradeable, imitable or substitutable. The contributory factors to these characteristics are that intangible assets are often developed over long time periods; benefit from asset mass efficiencies and inter-connectedness with other intangible assets; can be impacted by asset erosion and generate value with causal ambiguity. Their value often depends on the context in which they are used and they rarely have value in isolation from other tangible or intangible assets. Their ability to retain their scarcity is also paramount and regulatory protection is often vital.

4.4 MNE access to economic rent

Section 4.1 outlined that the main sources of economic rent are barriers to market entry; scarcity of resources; and real world complexity, including information asymmetry, uncertainty and the element of luck. Sections 4.2 and 4.3 have reviewed the theory of the firm, the characteristics of MNEs and the characteristics of intangible assets. All of these elements impact a MNE’s ability to access and sustain economic rent. This section analyses specifically whether each of these elements increases a MNE’s access to economic rent because it is operating across tax jurisdictions through dealings with related parties rather than independent parties.

The sources of economic rent identified above link nicely to the five OECD\textsuperscript{121} transfer pricing comparability factors (i) characteristics of the property or services; (ii) functional analysis, including assets, thereby incorporating scarcity of resources; (iii) contractual terms; (iv) economic circumstances – this encompasses barriers to market entry and really world complexity; and (v) business strategies. Therefore, by analysing the impact of the theory of the firm, pecuniary economies and economies of scale, scope and experience and the characteristics of intangible assets on the five comparability factors, this analysis will

\textsuperscript{120} Drahos (1996)
\textsuperscript{121} OECD (2010, 22 July)
incorporate the impact these elements have on a MNE’s ability to not only create MNE economic rent, but to also to access higher levels of economic rent in general.

The theory of the firm impacts the five comparability factors in the following ways. First, the value of intangible assets to which MNEs have access to will be higher as it is more likely they will have higher levels of investment in intangible assets and a MNE has less risk of intangible asset dissipation. Second, the ability to determine the terms of intra-group contracts falls within the contractual terms comparability factor and finally the ability to make decisions that benefit the MNE as a whole falls within business strategy.

The other MNE impacts of the theory of the firm, however, do not fit easily within the comparability framework provided. One way to assess these factors, being lower transaction costs, information asymmetry, and greater access to location savings, is to consider whether these items, in and of themselves, constitute intangible assets. Information asymmetry and the possibility that this may impact a MNEs ability to assess real world complexity and uncertainty can also be considered in the economic circumstances category.

The impact of pecuniary economies, economies of scale, scope and experience have traditionally only been referred to in transfer pricing analysis when considering their bearing on volume discounts. However, these economies impact each of the five comparability factors.

A MNE’s ability to develop a more extensive range of products and services will be greater due to economies across all aspects of the product development, enhancement, maintenance, protection and exploitation cycle.

The functional profile of a MNE will be impacted by pecuniary economies across all aspect of functions, assets and risks. For functions, economies will allow for fragmentation and specialisation in all areas from research and development to management expertise. Economies allow for enhancement of high value functions and performance of lower value functions more cost efficiently.

Both tangible and intangible assets are impacted by economies. Tangible assets, such as production facilities are impacted by the ability to increase investment in, fragment and specialise due to pecuniary economies and economies of scale and scope.
Economies impact upon a MNE’s ability to invest in all types of intangible assets. In particular, economies of scale, scope and experience allow specialisation and investment in human and relationship assets. These assets include knowledge systems (often informal ways of sharing knowledge\textsuperscript{122}), culture, employee’s experience, training etc.: all assets which are difficult for a group of independent entities operating across jurisdictions by way of external contract to invest in due to the “hold up” problem, potential asset dissipation and the difficulty in predicting the beneficiary of any resulting exploitation of the asset. Therefore, MNEs have a clear advantage in developing and exploiting these assets.

The other implication in the category of intangible assets is whether any of the advantages of gained by MNEs due to economies create an intangible asset. Things that fall into this category include access to volume discounts and greater access to equity and debt funding.

Risks are also impacted by economies as economies of scope allow for risk to be lowered and/or naturally hedged due to diversity of product, type and location of operations. Even the pooling of uncorrelated risks has been shown to reduce overall risk.\textsuperscript{123} Pecuniary economies also allow for volume discounts for any external costs incurred in managing risk; economies of scale allows for the fixed costs of managing risk to be spread; and economies of experience allows for better management of risk. Overall, MNEs have access to lower inherent risk levels and any residual risk is managed more cost efficiently.

The third comparability factor, contractual terms, is also impacted by economies. Due to their size, MNEs generally have more bargaining power when negotiating external contract terms. This obviously provides access to volume discounts (as noted above) but it also gives access to other benefits. These could include an entity with more bargaining power requiring a supplier to implement specific invoicing and delivery systems or deliver goods within a set time frame. The impact of such bargaining power encompasses all terms and conditions across external contracts.

The fourth comparability factor, economic circumstances, is more often thought of as an external factor which influences the environment in which a MNE operates. However, due

\textsuperscript{122} Long-standing processes and ways of dealing internally create value. The development of an “information system” as a way of dealing internally facilitates communication and information flow. This is an important resource Cecchini et al. (2013) p. 35.

\textsuperscript{123} MgGee and Thomas (1986), p. 153
to their size and market power, MNEs influence and contribute to the creation of the economic circumstances in which they operate. The pharmaceutical and chemical industries are illustrative of this point. As outlined by Drahos\textsuperscript{124} MNEs in the pharmaceutical and chemical industry have played a very large role in ensuring the patent system for pharmaceutical drugs and chemicals has been made as all-encompassing and enduring as possible.

Drahos notes “very often ‘MNEs’ hold more power than the nation states in which they operate. This power, combined with the absence of suitable international regulatory regimes, has allowed ‘MNEs’ to pursue self interest in an unrestrained fashion”.\textsuperscript{125} Drahos posits that MNEs in the pharmaceutical industry have achieved this by lobbying governments and achieving the linkage of intellectual property rights to bi and multi-lateral country trade agreements. The impact of this has been the creation of near -global patent protection with its administration and regulation performed by patent offices in each participating country in order to ensure continued compliance and access to trade agreements. Therefore, not only do entities have access to the global monopoly rents created through continually extended patent terms, these patents are regulated and administered by government bodies in each relevant jurisdiction.

Independent entities operating in just one jurisdiction, or across jurisdictions though independent party contracts, also have access to the patent protection system and the economic rents this system produces. However, not only can MNEs more readily accumulate higher levels of intangible assets (as outlined above), they are also more likely to have the bargaining power necessary (due both to their size and operations across multiple jurisdictions) to create, extend and protect favourable regulatory positions which in turn create barriers to market entry.

The final comparability factor of business strategies is also impacted by economies. Given a MNE is more likely to be large it has greater ability to pursue certain business strategies such as market penetration. One flow on effect of market penetration is creation of first mover advantages. First mover advantage often brings with it an implicit barrier to entry as the entry level investment required (whether by way of development of technology or

\textsuperscript{124} Drahos and Braithwaite (2002) and Drahos (1996). Also see Asmussen and Foss (2014) where it is noted that MNEs may come about “not as a vehicle for exploiting or creating competitive advantages, but as an ‘instrument of restraining competition between firms from different nations’”, quoting Hymer (1970).

\textsuperscript{125}Drahos (1996), p. 1 and 2
development and advertising of brand name etc) is so high. Economies of scale and experience compound the impact of the first-mover advantages by allowing a MNE to extend the first mover advantage to as broader range of products and markets as possible.

Intangible assets are vitally important to the creation and sustainability of economic rent due to their ability to create barriers to entry and the fact they are a scarce resource. Therefore, it is important to consider whether a MNE has increased access to intangible assets over entities that operate through independent parties. In this regard, four areas have been identified.

First, not all intangible assets are separably identifiable and saleable. They have an interconnectedness, causal ambiguity and ability to be impacted by their environment which is difficult to quantify and impossible to predict. How the various separate legal entities of a MNE interact to contribute, enhance and exploit a firm’s bundle of intangible assets is very difficult to determine. A MNE operating as a whole creates more intangible assets, and enables greater economic rent from the intangible assets it owns, than independent entities acting separately, or the intangible assets taken separably out of the business.

Second, volume and time matter. Intangible assets benefit greatly from economies of scale, scope and management, especially given the often very small marginal cost in applying them in a new context, for example, the application of a brand name to another product range. Further, the ability to consistently invest in research and development over long periods of time means that MNEs build up high levels of intangible asset stocks. While volume and time are also available to independent entities, it is much less likely than in the MNE context.

Third, protection is vital. MNEs avoid the investment hold up issue and asset dissipation concerns because they operate through controlled entities. This leads to greater investment in intangible assets. Further, due to their market power, MNE’s are often able to influence regulatory systems which provide protection to intellectual property and in some instances such as the pharmaceutical and chemical industries create the global protection of monopoly rents.

Intangible asset erosion is a real threat to intangible asset value. Often this erosion occurs quickly when a leap in technology occurs. Sometimes, these leaps in technology are contributed by a relatively new and small domestic entity (for example, Netflix, Uber). However, in today’s global economy, these small entities are either acquired by a MNE or
quickly become MNE’s themselves in order to gain maximum advantage from the intangible assets they have developed. In order to protect themselves against such asset erosion, existing MNEs continually invest in research and development and the enhancement of their existing bundle of intangible assets, making the elements outlined above increasingly important.

In summary, the more a firm is able to build and control the elements that generate economic rent, the more economic rent it can generate and sustain. Operating as a MNE provides greater access to the factors that generate economic rent and it also creates additional profits, termed in this paper as MNE economic rent. Not only are particular elements impacted directly by operating as a MNE, but indirect interactions also occur increasing the potential to access both general economic rent and to create MNE economic rent.

It must be recognised however, that the drivers, materiality and sustainability of economic rent and MNE economic rent are different in each industry. For example, the source of economic rent in the energy and resource sector, being the finite natural resource is very different to the source of economic rent for an internet company whose economic rent may derive from global use and sustainability of this rent from first mover advantage or market share.

The author argues, in line with arguments put forward by Vann,\textsuperscript{126} that in transfer pricing analysis, a MNE’s profitability must be recognised as deriving from three main sources: the risk-free return; the return for risk and economic rents. The above analysis illustrates that the return relating to economic rents can be further split between general economic rent, greater access to the factors that generate this rent due to operating as a MNE and finally MNE economic rent.

Table 2 below summarises the components of economic rent classified into the five comparability factors. It also includes references to the relevant commentary in both the 2010 Guidelines\textsuperscript{127} and 2015 Guidelines\textsuperscript{128}, which are analysed in detail in Sections 4.5 and 5 respectively.

\textsuperscript{126} These sources are outlined by Vann, Vann (2014), pp. 438-439
\textsuperscript{127} OECD (2010, 22 July)
\textsuperscript{128} OECD (2015a)
<table>
<thead>
<tr>
<th>Characteristics of Property &amp; Services</th>
<th>Impact on MNE’s ability to access economic rent</th>
<th>2010 Guidelines</th>
<th>2015 Guidelines</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product diversity</strong></td>
<td><strong>Product range:</strong> Economies of scale, scope and experience will allow for the development of a more extensive product range</td>
<td>Chapter I: The Arm’s Length Principle: paragraph 1.10</td>
<td>Chapter I Section D.8.: MNE group synergies</td>
</tr>
<tr>
<td><strong>Functional Profile</strong></td>
<td><strong>More valuable functions:</strong> allows for investment in specialised functions across all aspects of a MNEs business, including R&amp;D, management expertise etc.</td>
<td>Chapter I: The Arm’s Length Principle: paragraph 1.10</td>
<td>Chapter I Section D.8.: MNE group synergies</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td><strong>Production facilities:</strong> allows for investment in production facilities and processes combined with greater access to fragmentation and specialisation</td>
<td>Chapter I: The Arm’s Length Principle: paragraph 1.10</td>
<td>Chapter I Section D.8.: MNE group synergies</td>
</tr>
<tr>
<td><strong>Intangible Assets</strong></td>
<td><strong>Lower transaction costs</strong></td>
<td>Chapter VI: Intangible Assets</td>
<td>Chapter I Section D.8.: MNE group synergies Revised Chapter VI: Intangible Assets</td>
</tr>
</tbody>
</table>

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129 OECD (2010, 22 July)
130 OECD (2015a)
131 Unless stated otherwise ‘economies’ refers to pecuniary economies and economies of scale, scope and experience
<table>
<thead>
<tr>
<th>Comparability factors</th>
<th>Economic rent theory</th>
<th>Impact on MNE’s ability to access economic rent</th>
<th>2010 Guidelines 132</th>
<th>2015 Guidelines 134</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information asymmetry</td>
<td>Theory of firm</td>
<td><strong>Information asymmetry:</strong> greater access to information due to internalising transactions</td>
<td>Chapter VI: Intangible Assets</td>
<td>Chapter I Section D.8.: MNE group synergies Revised Chapter VI: Intangible Assets</td>
</tr>
<tr>
<td>Location savings</td>
<td>Theory of firm</td>
<td><strong>Location savings:</strong> greater access to most cost efficient production locations</td>
<td>Chapter IX Section E: Location Savings</td>
<td>Chapter I Section D.6.: Location savings</td>
</tr>
<tr>
<td>Human and relationship assets</td>
<td>Economies</td>
<td><strong>Increased human and relationship assets:</strong> allows for specialisation of knowledge, experience and training, including the ability of a MNE to develop its own processes and language allowing for information sharing across the value chain 132</td>
<td>Chapter VI: Intangible Assets</td>
<td>Chapter I Section D.7.: Assembled workforce Revised Chapter VI: Intangible Assets</td>
</tr>
<tr>
<td>Volume discounts</td>
<td>Pecuniary economies</td>
<td><strong>Volume discounts:</strong> Due to the pure size of the MNE volume discounts across a whole range of products and services will be available</td>
<td>Chapter IX Section F: Example central purchasing function</td>
<td>Chapter I Section D.8.: MNE group synergies</td>
</tr>
<tr>
<td>Access to equity and debt funding</td>
<td>Pecuniary economies &amp; economies of scope</td>
<td><strong>Access to global equity and debt markets:</strong> MNEs have access to cheaper and larger volumes of equity and debt funding due to various factors including size, diversity and operations in the large financial centres in developed countries 133</td>
<td>Chapter I: The Arm’s Length Principle: paragraph 1.10 Parental affiliation: Intra-group services: paragraph 7.13</td>
<td>Chapter I Section D.8.: MNE group synergies</td>
</tr>
</tbody>
</table>

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132 Cecchini et al. (2013), p.33-35
133 Yeaple (2013), p. 208
<table>
<thead>
<tr>
<th>Comparability factors</th>
<th>Economic rent theory</th>
<th>Impact on MNE’s ability to access economic rent</th>
<th>2010 Guidelines</th>
<th>2015 Guidelines</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating as a whole is an intangible asset</td>
<td>Characteristics of intangible assets</td>
<td><strong>Operating as a whole is an intangible asset:</strong> intangible assets have an interconnectedness, causal ambiguity and ability to be impacted by their environment which means that operating as a whole creates an intangible asset in and of itself</td>
<td>Chapter VI: Intangible Assets</td>
<td>Chapter I Section D.8.: MNE group synergies Revised Chapter VI: Intangible Assets</td>
</tr>
<tr>
<td>Ability to develop, enhance, maintain, protect and exploit intangible assets</td>
<td>Economies Characteristics of intangible assets</td>
<td><strong>Higher levels and more specialised investment in IA:</strong> economies of scale and scope allow fixed costs of development, enhancement, maintenance, protection and exploitation to be spread across a much higher volume. Economies of experience also contributes to each of these categories</td>
<td>Chapter VI: Intangible Assets</td>
<td>Chapter I Section D.8.: MNE group synergies Revised Chapter VI: Intangible Assets</td>
</tr>
<tr>
<td></td>
<td>Theory of firm Characteristics of intangible assets</td>
<td><strong>Investment hold up avoided:</strong> Hold-up is avoided due to the increased ability to exploit and the decreased risk of dissipation therefore resulting in higher level of investment in IA</td>
<td>Chapter VI: Intangible Assets</td>
<td>Chapter I Section D.8.: MNE group synergies Revised Chapter VI: Intangible Assets</td>
</tr>
<tr>
<td></td>
<td>Theory of firm Characteristics of intangible assets</td>
<td><strong>Less inherent IA dissipation risk:</strong> because the IA is being exploited by controlled entities there is far less risk of the IA being infringed upon or the brand being harmed</td>
<td>Chapter VI: Intangible Assets</td>
<td>Chapter I Section D.8.: MNE group synergies Revised Chapter VI: Intangible Assets</td>
</tr>
<tr>
<td>Risks</td>
<td>Economies</td>
<td><strong>Decreased inherent risk:</strong> economies of scope allows for risk to be lowered and/or naturally hedged due to diversity of product, type and location of operations.</td>
<td>Chapter I: The Arm’s Length Principle: paragraph 1.10</td>
<td>Chapter I Section D.8.: MNE group synergies</td>
</tr>
<tr>
<td>Comparability factors</td>
<td>Economic rent theory</td>
<td>Impact on MNE’s ability to access economic rent</td>
<td>2010 Guidelines</td>
<td>2015 Guidelines</td>
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</tr>
<tr>
<td>Decreased costs of managing risk</td>
<td>Economies</td>
<td>Decreased costs of managing risk: pecuniary economies allow for volume discounts for any external costs incurred in managing risk, economies of scale allows for the fixed costs of managing risk to be spread and economies of experience allows for better management of risk</td>
<td>Chapter IX Section F: Example central purchasing function</td>
<td>Chapter I Section D.8.: MNE group synergies</td>
</tr>
<tr>
<td>Contractual Terms</td>
<td></td>
<td>Access to tax savings by means of intra-group contracts: intra-group contracts allow for shifting of functions, assets and risks to low tax jurisdictions</td>
<td>Chapter I Section D.2.: Recognition of the accurately delineated transaction</td>
<td>Chapter I Section D.2.: Recognition of the accurately delineated transaction</td>
</tr>
<tr>
<td>Bargaining power</td>
<td>Pecuniary economies</td>
<td>Ability to dictate independent party contract terms and conditions: MNEs increased bargaining power can result in more favourable external contract terms and conditions</td>
<td>Chapter I: The Arm’s Length Principle: paragraph 1.10</td>
<td>Chapter I Section D.8. MNE group synergies</td>
</tr>
<tr>
<td>Economic Circumstances</td>
<td>Pecuniary economies</td>
<td>Market power: MNEs purely due to their size are more likely to have a higher market share and thus greater market power. MNEs are also more likely to be able to influence regulation of their industry which in some instances creates monopoly rent (for example, patent regulation in the pharmaceutical industry)</td>
<td>Chapter I: The Arm’s Length Principle: paragraph 1.55</td>
<td>No additional</td>
</tr>
<tr>
<td>Real world complexity</td>
<td>Theory of firm</td>
<td>Information asymmetry: greater access to information due to internalising transactions</td>
<td>None</td>
<td>No additional</td>
</tr>
<tr>
<td>Comparability factors</td>
<td>Economic rent theory</td>
<td>Impact on MNE’s ability to access economic rent</td>
<td>2010 Guidelines</td>
<td>2015 Guidelines</td>
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<tr>
<td>Business Strategies</td>
<td></td>
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<tr>
<td>Ability to make</td>
<td>Theory of firm</td>
<td>Ability to make global decisions: ability to manage by means of control rather than contract, gives absolute ability to make decisions that benefit the MNE as a whole but which may result in one or more jurisdictions incurring economic loss. Ultimately this results in lower transaction costs.</td>
<td>Chapter I: The Arm’s Length Principle: paragraph 1.10</td>
<td>No additional</td>
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<tr>
<td>decisions that benefit</td>
<td></td>
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<td></td>
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<tr>
<td>the MNE as a whole</td>
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</tr>
<tr>
<td>Greater access to</td>
<td>Economies</td>
<td>Barriers to entry/first mover advantages: as MNEs are more likely to be large, it has greater ability to pursue certain business strategies such as market penetration. The flow on effect of this is they are more likely to be able to create, exploit and retain barriers to entry and first mover advantages</td>
<td>None</td>
<td>No additional</td>
</tr>
<tr>
<td>barriers to entry and</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>first-mover advantages</td>
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</tbody>
</table>
4.5 Limitation 4: MNE Economic Rent

The existence of ‘MNE economic rent’ (while not necessarily using this term) and the limitations of the arm’s length principle in dealing with it, have long been recognised by the academic literature. The following authors have all contributed to this conversation: Avi-Yonah\textsuperscript{134}, Langbein\textsuperscript{135}, Li\textsuperscript{136}, Oestricher\textsuperscript{137}, Roin\textsuperscript{138}, Schon\textsuperscript{139} and Vann\textsuperscript{140}. The work in this area generally has either considered a specific aspect of MNE economic rent, for example, Kane’s work on location savings, or has recognised its existence in general terms.

The 2010 Guidelines also recognise the existence of MNE economic rent by virtue of “economies of scale and interrelation of diverse activities created by integrated businesses” but notes there are “no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises.”\textsuperscript{141} However, the 2010 Guidelines then apply the arm’s length principle on the basis “of treating the members of a MNE group as operating as separate entities rather than as inseparable parts of a single unified business.”\textsuperscript{142} The author argues that this ultimately results in an application of the arm’s length principle which generally overlooks the impact of MNE economic rent.

This is illustrated by the centralised intangible asset model that is explained in Section 2 above. In this model, the operational subsidiaries being the contract Research and Development subsidiary, the Manufacturer, the Regional Hub and the Marketing/Distributor are all rewarded based on their limited functional and risk profile. Prima facie, the transfer pricing method used will be the TNMM and this will target a specified net margin to be earned by each of these subsidiaries. By default, the Intangible Asset Owner will be allocated all the residual profit from the value chain. Any MNE economic rent, and in fact most of the general economic rent, will be allocated to the Intangible Asset Owner. One of

\textsuperscript{135} Langbein (1986) and Langbein (1990). Langbein (1986) also framed this issue as resulting from the problems that arise from pricing shared factor relationships.
\textsuperscript{136} Li (2002) and Li (2012)
\textsuperscript{137} Oestreich (2012)
\textsuperscript{138} Roin (2012)
\textsuperscript{139} (Schon, 2010, 2014)
\textsuperscript{140} Vann (2003), page 140 and Vann (2010), p. 307
\textsuperscript{141} OECD (2010, 22 July), paragraph 1.10 and again in paragraph 9.4 in the business restructuring chapter where it is stated “business representatives…explained that among the business reasons for restructuring are the wish to maximise synergies and economies of scale, to streamline the management of business lines and to improve the efficiency of the supply chain, taking advantage of the development of Internet-based technologies that has facilitated the emergence of global organisations”.
\textsuperscript{142} OECD (2010, 22 July), paragraph 1.6
the main reasons for this result is that when applying the TNMM, the target net margin will be determined based on independent entities that perform similar functions as the MNE group entities, but for independent parties. The independent parties will not be earning any MNE economic rent and therefore the target net margins established for the MNE subsidiaries will not include an element of MNE economic rent either.

4.6 Safeguard 4: Profit split method

As noted in Sections 2.3.3 and 3.7 and often pointed out,143 the method which best provides some scope for the allocation of MNE economic rent to each MNE subsidiary that contributes to the global value chain is the profit split method. However, this method is only applied if it is considered that either the operations of the MNE are highly integrated or where two or more separate legal entities in a MNE group make significant unique contributions to generate the profit. Given the nature of MNEs and the way they operate, as outlined in this section, proving a MNE has a high level of integration may be achievable. However, the question then becomes how the residual profit should be split and it will be important to consider whether the operational subsidiaries own or at least contribute to, the intangible assets of the group.

In respect of the second condition requiring two or more separate legal entities in a MNE group making significant unique contributions, this is considered in general to only occur if more than one MNE subsidiary in the value chain owns or contributes to intangible assets. The guidance on recognising intangible assets in general is covered in Section 3.7.

It is also important to consider whether any intangible assets are created by virtue of operating as a MNE. As outlined in Section 4.4 the possible assets include: access to lower transaction costs; information asymmetry (or access to information not available to independent parties); increased access to human and relationship assets; operating as a whole as opposed to separate parts (including the ability to make decisions for the global good); access to higher levels of investment in intangible assets (due to avoidance of investment holdup and less inherent intangible asset dissipation risk); market power and first mover advantage.

None of these elements fit nicely within the description of intangible assets in the 2010 Guidelines. The only matters that may be considered as part of a transfer pricing analysis

143 BEPS (2015)
would be the human and relationship assets and the impact of market power and first mover advantage. Where it can be illustrated the local entity has developed and owns unique and significant human and relationship assets that have a material impact and it is considered that appropriate comparables cannot be found, the profit split method may be used. In respect of the market power and first mover advantage their impact should be taken into account when considering the economic comparability factors. However, unless it can be illustrated that the local entity substantially contributes to either of these factors, the benefits associated with these elements will be attributed to the Intangible Asset Owner.

4.7 Safeguard 5: MNE economic rent

There are a number of areas in the 2010 Guidelines which touch on MNE economic rent. These include incidental group benefits, location savings and assembled workforce. Associated with these areas is whether any of them constitute an intangible asset, as if so, this may more likely result in the application of the profit split method and subsequent allocation of MNE economic rent to more than one MNE legal entity. These areas are examined below.

4.7.1 Safeguard 5.1: Incidental group benefits

The 2010 Guidelines provide that if an entity in the MNE group “obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed”\(^{144}\) then it should not be considered as receiving an intra-group service and no charge should be made. The example given is where a related party, by reason of it being part of a MNE group, is assessed as having a higher credit rating than if it was assessed as a stand-alone entity devoid of a MNE group. That is, the local subsidiary gains an increased credit rating and decreased interest cost due to its parental affiliation. However, because neither the parent, nor any other entity in the MNE group, have not done anything explicitly or incurred extra costs, the 2010 Guidelines provide that the local subsidiary should not be charged for receiving this benefit.

The impact of this approach is the local subsidiary will have decreased interest charges and a higher level of profits. The result is that for transfer pricing purposes, the local subsidiary has been able to retain part of the MNE economic rent derived by the global group.

\(^{144}\) OECD (2010, 22 July), paragraph 7.13
The other area where this approach may have an impact is purchase discounts or other favourable contract terms given by an independent supplier to a local subsidiary because it is part of a global group. The reason for the discount may be the prospect of future opportunities or an implied higher credit rating etc. Again, because these benefits are incidental the local subsidiary would not be charged by the MNE and the decreased costs will be retained by the local subsidiary. However, if the local subsidiary’s transfer pricing is determined under the TNMM, it will target a net operating margin (before interest costs) and therefore any cost savings will be effectively returned to the Intangible Asset Owner through a higher import price for the goods or a lower amount of mark-up provided under a cost plus return, unless they are specifically identified and added to the TNMM return (or possibly practically dealt with by targeting a higher point in the TNMM range).

4.7.2 Safeguard 5.2: Central purchasing function and volume discounts

The implications of a centralised purchasing function are discussed in Chapter IX on business restructures of the 2010 Guidelines.\textsuperscript{145} This commentary is particularly non-committal and notes a number of times that the outcome will depend on the facts and circumstances of the case. It provides discussion on situations where the centralised purchasing function results in decreased costs for the group, but spends a large part of the discussion on where the function results in increased costs to the group. This later discussion appears to have limited applicability as it is unlikely a MNE would continue with a function that resulted in increased costs.

The discussion finally notes “there might be some cases where the cost savings (or costs) generated by the centralisation of the purchasing function would be shared amongst the central purchasing entity and the [related parties]...through a form of profit split”. It does not provide any detailed discussion on when these cases will occur. One can surmise this may occur when each party’s contribution to the volume of purchases has resulted in a volume discount which has benefited each member of the MNE group. Therefore, if a component of MNE economic rent can be specifically linked to cost reductions due to the volume of purchases, it appears the 2010 Guidelines suggest these savings should be proportionally shared throughout the group. The entity that performs the central purchasing function should assumedly be rewarded for performing these functions with an arm’s length return.

\textsuperscript{145} OECD (2010, 22 July), paragraphs 9.154 to 9.160
However, as noted in the incidental benefit discussion above, if the local subsidiaries are rewarded with a TNMM using either a net operating margin (before interest costs) or a cost plus margin, the benefit of any cost reductions may ultimately be returned to the Intangible Asset Owner in a centralised intangible asset model, unless dealt with by adding the benefit to the TNMM result or targeting a higher point in the TNMM range.

4.7.3 Safeguard 5.3: Location savings

Location savings are addressed in Chapter IX of the 2010 Guidelines in the discussion on business restructures. The outcome of the analysis is that the entity performing the manufacturing or service functions in the low cost jurisdiction should be rewarded based on comparable transactions and returns benchmarked from the local market. If independent comparable entities are performing similar functions or services and they are not retaining any of the location savings, then neither should the related party entity. In this circumstance, if location savings exist, they will be allocated to the purchasing entity, which in the case of a centralised intangible asset model, is the Intangible Asset Owner. The only circumstance in which any of the location savings will be awarded to the local entity would be if the entity has some form of intangible asset, such as unique technical know-how or if it can be illustrated that independent local comparable entities have retained such savings.

4.8 Summary: MNE Economic Rent in the 2010 Guidelines

The overall treatment of MNE economic rent under the 2010 Guidelines is that it is mostly disregarded except in cases where a MNE subsidiary has undertaken deliberate action to either contribute to it or access it. The exception to this general approach is the impact on subsidiary credit ratings, where implicit parental affiliation increases the ‘stand-alone’ credit rating of the subsidiary. Any resultant decrease in interest charges or guarantee fees are allowed to be retained by the subsidiary therefore allocating it a portion of MNE economic rent.

As illustrated by the centralised intangible asset model the ultimate result can be that all MNE economic rent is retained by the Intangible Asset Owner. As noted by Vann, this allocation of the “residuum” to the Intangible Asset Owner is in direct contradiction to the

147 A detailed analysis of location savings and the ability to shift them to low tax jurisdictions is provided by Kane (2015)
theory of the firm given MNEs “are able to make greater profits locally by operating locally, implying as a starting point that the residuum should generally be allocated to all the places where the firm is operating...and that the application of market prices on an outsourcing basis [as illustrated by the centralised intangible asset model] misallocates the residuum”.¹⁴⁸ Section 4 illustrates the extensive impact operating as a MNE can have and that for some industries and business models MNE economic rent may be a large portion of the group’s profitability. Langbein¹⁴⁹ has suggested that in some cases this can be as high as half the total revenue. Therefore, the limited regard for MNE economic rent under the 2010 Guidelines is especially problematic.

5. Impact of BEPS Actions Items 5 and 8 to 10 on the safeguards of the arm’s length principle

The OECD BEPS project aims to address weaknesses in international and domestic tax law that are contributing to base erosion and profit shifting, including limitations in transfer pricing rules. In most instances the work has bolstered the existing safeguards of the arm’s length principle. Therefore, this section considers the impact of the final BEPS reports issued in October 2015 on the safeguards of the arm’s length principle outlined in sections 3 and 4 above.

5.1 Safeguard 1: Pricing the substance of the transaction

Two final reports, being Actions Items 8 to 10 on Transfer Pricing and Action Item 5 on Harmful Tax Practices, herein referred to as the 2015 OECD Guidelines, affect the safeguards associated with pricing the substance of the transaction, cost contribution arrangements and patent box regimes. The impact on each of these areas is analysed below.

5.1.1 Safeguard 1.1: Substance in general

As explained, in section 3.2.1 the 2010 Guidelines allowed related party contracts to be disregarded in two exceptional circumstances. The first was where the economic substance of the transaction did not reflect its written form. This factor is now dealt with in much more detail and moved to the revised Section D.1. of Chapter I.¹⁵⁰ The existing

¹⁴⁸ Vann (2010), p. 322
¹⁴⁹ Langbein (1990), p.4
¹⁵⁰ OECD (2015a)
Chapter 1, Section D.1 of the 2010 Guidelines\textsuperscript{151} has been renamed to “identifying the commercial or financial relations” and rewritten to include a much lengthier commentary on determining the accurately delineated transaction.\textsuperscript{152} These changes impact the assessment of economic substance.

The 2010 version focused on comparability noting it is imperative an accurate comparison is made between the related party transaction and any potentially comparable independent party transactions by ensuring all economically relevant characteristics are considered. The section then provides a somewhat brief description of each of the 5 comparability factors.

The new Section D.1. changes the focus from what needs to be considered when performing a comparability analysis, to how you determine the starting point of the analysis. That is, what the related party transaction is, or the “accurately delineated”\textsuperscript{153} transaction. This analysis begins with a broad-based understanding of the industry sector including factors that affect sector performance such as business strategies, markets, products, the supply chain of the MNE and the key functions performed, material assets used and important risks assumed. The analysis is then narrowed to understanding how each entity within the MNE group operates, including consideration of what each entity does and its commercial and financial relations with its related parties as expressed in the transactions between them.\textsuperscript{154}

In line with the change in focus, contractual terms have been promoted from third to the first comparability factor discussed. While the “substance” discussion has been moved and expanded, in general terms it follows the same principles of the 2010 Guidelines being that substance is based on the conduct of the parties in conjunction with an analysis of the four other comparability factors. If substance differs from the legal form, the substance of the transaction forms the basis of the transfer pricing analysis.

The most substantial change is a new section devoted to analysing risks in commercial and financial relations, including a new 6 step process.\textsuperscript{155} This section also introduces the

\textsuperscript{151} OECD (2010, 22 July), Chapter I, Section D.1, paragraphs 1.33 to 1.63
\textsuperscript{152} OECD (2015a), Chapter 1, Section D.1., paragraphs 1.33 to 1.118
\textsuperscript{153} OECD (2015a), paragraph 1.33
\textsuperscript{154} OECD (2015a), paragraph 1.34 and 1.35
\textsuperscript{155} The 6 steps are (i) identify the economically significant risks (ii) examine the related party contractual allocation of risk (iii) determine which related party entities exercise control over the risk and have the financial
concepts of risk management and the financial capacity to assume risk. Risk management
is the ability, and actually making the decisions to, (i) take on, lay off or decline a risk-
bearing opportunity; (ii) determine whether and how to respond to risks associated with the
opportunity, and (iii) determining whether measures should be taken to mitigate risk.156
Financial capacity to assume risk requires the entity to have access to funding to allow it to
(i) take on or lay off risk, (ii) pay for risk mitigation functions, and (iii) bear the consequences
of the risk if it materialises.157

In order for an entity to be allocated a risk, it must have the ability to exercise control over
the risk, requiring both the capability and functional performance of this control, and the
financial capacity to assume the risk. If the entity does not have both of these, this will
bring into question the related party allocation of risk.158 In respect of financial capacity to
take on the risk, an intra-group entity that provides funding to the party taking on the risk
does not necessarily take on the underlying risk and if the entity does no more than provide
the funds then its reward will be limited to the risk-free return.159

These concepts and commentary definitely provide an increased focus on aligning risk
allocation with economic substance. However, there are some areas in the 2015
Guidelines which appear to limit the impact of such concepts by allowing the risk entity to
outsource risk mitigation functions. The impact is that as long as the entity employs
appropriate employees that have the capability (and actually make the decisions) to
determine whether to take on, retain or lay off the risk-bearing opportunity; determine
whether and how to respond to the risks associated with the opportunity; take measures
that affect the risk outcomes; and manage the outsourced functions,160 then this is sufficient
for the entity to retain the risk allocation. Further, the 2015 Guidelines also provide
examples of where risk is separated from functions, allowing for continued separation of

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156 OECD (2015a), paragraph 1.61
157 OECD (2015a), paragraph 1.64
158 OECD (2015a), paragraph 1.98
159 OECD (2015a), paragraph 1.103
160 This includes the ability to determine the objectives of the outsourced activities, determine what entity to
hire to provide the risk mitigation functions and assess the performance of that entity and make modifications
(including terminating the contract) then this is sufficient for the entity to be able to retain the risk, even though
the risk mitigation strategies are performed by another entity OECD (2015a), paragraph 1.65

DRAFT – Please do not quote without permission of the author 61
intangible asset ownership from functions and the separation of risk from functions.\textsuperscript{161} These examples are supported by this statement about contract R&D arrangements:

“if the contractual arrangement between the associated enterprises is a contract R&D arrangement that is respected under the requirements of ...[section D.1.2.1]... remuneration for risk mitigation functions performed through the development activity would be incorporated into the arm’s length services payment. Neither the intangible risk itself, nor the residual income associated with such risk, would be allocated to the service provider.”\textsuperscript{162}

This separation of intangible assets from underlying functions is also supported by the 2015 Guidelines approach to the performance and control of functions in the revised Chapter VI on intangible assets. This section again improves on the 2010 Guidelines by stating it is implied that “if the legal owner of intangibles is to be entitled ultimately to retain all of the returns derived from exploitation of the intangibles it must perform all of the functions, contribute all assets used and assume all risks related to the development, enhancement, maintenance, protection and exploitation of the intangible”.\textsuperscript{163} However, this statement is somewhat lessened by the two sentences which follow it. The first outlines that a MNE must not be required to structure their intangible asset ownership in a particular way. The second stating “it is not essential that the legal owner physically performs all of the functions related to...[the] intangible through its own personnel”. Paragraph 6.56 outlines the “certain important functions” that “have special significance” and which, if performed by the entity, allow it to retain 100 percent ownership (and 100 percent residual profit allocation) of the intangible asset. The special significant important functions are essentially the ability to determine the direction, continuation and ceasing of research and development activities.\textsuperscript{164} Several examples in the Annex to Chapter VI also include contract research and development arrangements and as long as the intangible asset owner has the ability to make the decisions and the financial capacity to take on the funding

\textsuperscript{161} See example 28, paragraphs 101 to 103 of Annex to Chapter VI and examples 1 and 2 in Chapter I, Section D.1., paragraphs 1.83, 1.87 & 1.101 and paragraphs 1.84, 1.87 & 1.102 respectively OECD (2015a), OECD (2015a), paragraph 1.62
\textsuperscript{162} OECD (2015a), paragraph 6.51
\textsuperscript{163} OECD (2015a), paragraph 6.51
\textsuperscript{164} The 2015 Guidelines outline that these “important functions may include, among others, design and control of research and marketing programmes, direction of and establishing priorities for creative undertakings including determining the course of ‘blue sky’ research, control over strategic decisions regarding intangible development programmes, and management and control of budgets...may also include important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible” OECD (2015a), paragraph 6.56
risk, then the separation of the research and development functions and intangible asset ownership are accepted.\textsuperscript{165}

Due to the continued allowance of outsourcing of risk mitigation functions and research and development activities (paragraphs 1.65, 6.51 and 6.56) the practical effect of the changes to Section D.1. can be seen to be somewhat limited. As noted by Vann the “idea that a small group of people attract the major share of profit...[has]...been seized upon by tax advisers and used in restructuring of firms by moving such personnel to more attractive tax climates”\textsuperscript{166} and further the modern MNE consists of “a series of hierarchies, with the direction of employees going far down the structure...it is the direction of the resources of the firm, human and otherwise, that is relevant and even low-level employees are involved in that direction...the quality of work on the factory floor has a significant impact on firm profit.”\textsuperscript{167}

This separation of intangible asset ownership from functions will still be possible as well as separation of risks from functions and assets. Nevertheless, the 2015 Guidelines have bolstered the commentary on substance and MNE groups may need to make a few changes on the ground to ensure their intangible asset ownership remains centralised and satisfies the revised commentary on substance.\textsuperscript{168} By reference to the centralised intangible asset model, the Intangible Asset Owner will at least have to employ a small number of reasonably senior personnel who are capable of making the decisions regarding risk and be qualified to direct and manage any outsourced functions, including research and development activities. In respect of limited risk entities, MNE groups may need to examine employment of senior personnel and where previously these could possibly have been retained in limited risk entities\textsuperscript{169} these employees may need to be employed by the Intangible Asset Owner or in a management service provider entity. If the later strategy is

\textsuperscript{165} See examples 14 and 23 in OECD (2015a), Annex to Chapter VI, paragraphs 46 to 48 and 83 to 85 respectively
\textsuperscript{166} Vann (2010), p. 329
\textsuperscript{167} Vann (2010), p. 330
\textsuperscript{168} See examples 1 to 6 and 14 to 17 in OECD (2015a) Annex to Chapter VI, paragraphs 1 to 15 and 46 to 63 respectively
\textsuperscript{169} Often if this was done, the employees that performed duties which extended beyond a limited risk profile were provided with a cost plus service fee. This allowed them to be segregated from the limited risk operational profile. It also had very little impact on the level of income derived in the local entity jurisdiction as even if the cost plus margin was large, it was normally on a relatively insignificant cost base and the total fee was only a small proportion of the global profit chain.
adopted, the management service entity may need to be allocated some of the risk profile and its remuneration may need to include some element of residual profit or loss.

The only other proviso in respect of limited risk entities is that “the form of remuneration cannot dictate inappropriate risk allocations”. That is, just because an entity is remunerated on a cost-plus basis, this remuneration form cannot be used as the reasoning for concluding it is a limited risk entity. However, as noted previously, because a MNE can control the functional profile of its subsidiaries it is unlikely this proviso will cause any practical impediments to a MNE utilising a centralised intangible asset model.

5.1.2 Safeguard 1.2: Cost contribution arrangements

As noted in section 3.2.2, cost contribution arrangements have allowed for the effective centralisation of intangible assets, usually with the legal ownership and US exploitation rights held by a US entity and the rights to exploit the intangible assets in all markets outside the US held by an entity that can take advantage of a low tax jurisdiction. The 2015 Guidelines include a rewritten Chapter VIII on Cost Contribution Arrangements with the overriding criteria to ensure cost contribution arrangements “are appropriately analysed and produce outcomes that are consistent with how and where value is created”.

The new chapter provides that participation in a cost contribution arrangement will only be respected if there is a reasonable expectation the party will benefit from, and be capable of exploiting the outputs of, the cost contribution arrangement; the party has the capability to and actually exercises control over the specific risks it assumes under the arrangement; and the party has the financial capacity to assume the allocated risks. Further, cost is generally not an appropriate contribution base if it does not provide a reliable basis for determining the relative value of the contributions of the parties. The analysis of cost contribution arrangements is subject to the same process as other transactions, i.e. the written contracts provide the starting point but then the 6 risk steps are applied with the conduct of the parties and the ability to take on risk and direct the significantly special important functions being examined. Therefore, if the contribution to the arrangement by one party is purely the contribution of funds (assuming the party has the financial capacity

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170 OECD (2015a), paragraph 1.81
171 OECD (2015a)
172 OECD (2015a), page 162
173 OECD (2015a), paragraphs 8.13 and 8.14
174 OECD (2015a), paragraph 8.28
and the capability to assess the taking on of the financial risk), that party’s reward will be limited to the risk-adjusted return on its funding commitment.  

Again though, it is not essential for the participant in the cost contribution arrangement to perform the day-to-day risk mitigation activities. As long as the entity has the capability to determine the objectives, monitor them and determine whether to adapt or terminate the outsourcing arrangement that is sufficient. Therefore, like the changes to intangible assets and risk allocation, while the participant to the cost contribution arrangement now needs to employ sufficiently capable and senior people to be able to make the directing decisions, because all other activities can be outsourced, the changes in the guidelines would seem to have minimal impact.  

The other major change is that buy-in payments and ongoing contributions are now also subject to the new guidance on hard to value intangibles (refer Section 5.3 below), meaning that ex post information may be used to assess the adequacy of the buy-in payment and ongoing contributions unless the taxpayer can illustrate the price was calculated taking into account all reasonably available foreseeable information.

5.1.3 Safeguard 1.3: Patent box regimes

Patent box regimes provide low tax rates for income generated from the exploitation of intangible assets owned or developed in the particular country. As noted in section 3.2.3, most patent box regimes have historically allowed outsourcing of the actual research and development. Action 5: Countering Harmful Tax Practices More Effectively, taking into account Transparency and Substance has substantially impacted this area by introducing a new “nexus test”. This test permits “jurisdictions to provide benefits to the income arising out of..[intangible assets].. so long as there is a direct nexus between the income receiving benefits and the expenditures contributing to that income”. As such, the concessional treatment is only allowed on the proportion of income equal to the proportion of expenditure incurred by the entity directly in the jurisdiction versus total expenditure. The paragraph goes onto state that “the purpose of the nexus approach is to grant benefits only to income that arises from IP where the actual R&D activity was undertaken by the taxpayer itself”.

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175 See examples 4 and 5, OECD (2015a) Annex to Chapter VIII, pages 180-181
176 OECD (2015a), paragraph 8.15
177 OECD (2015b), paragraph 28
Where a taxpayer has outsourced research and development activities to related parties in other jurisdictions, this will decrease the level of income which can qualify for the concessional treatment. Therefore, eventually this new test should decrease the effectiveness of patent box regimes. However, the rules do provide some concessions, including an uplift factor of 30% of qualifying expenditure in some circumstances. The test also relies on the allocation of expenditure between qualifying expenditure, non-qualifying expenditure and expenditure that does not result in the development of an IP asset at all, meaning there are likely to be areas where the calculation can be manipulated. Further, existing regimes (which are unlikely to have a nexus test) are grandfathered until 30 June 2021. Also it is important to note that if the MNE group is benefiting from being resident in a country with an overall low corporate tax rate or some other tax planning technique, the new nexus test will have no impact.

As a final point, even if the ability of a MNE to access low corporate tax rates is altered by changes to accrual taxation provisions (i.e. CFC provisions) and reduction in Patent Box Regimes, unless the approach to economic rent, including MNE economic rent, is amended there would still be an over allocation of profit to the intangible asset owner, with a corresponding under-allocation to the MNE operational subsidiaries, as explained further in Section 5.5.

5.2 Safeguard 2: Reconstruction

The possible reconstruction of intra-group transactions is now dealt with in the rewritten Section D.2 of Chapter I. The starting point for this section is now the accurately delineated transaction which will reflect the substance of the arrangements as required by Section D.1. of Chapter I. There is only one exceptional circumstance when this transaction will be disregarded. This will occur when “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

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178 OECD (2015b), paragraph 40
179 An IP asset is defined as “patents and other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, were such processes are relevant. IP assets that are functionally equivalent to patents are (i) patents defined broadly, (ii) copyrighted software, and (iii) in certain circumstances...other IP assets that are non-obvious, useful, and novel” OECD (2015b), paragraph 34
180 OECD (2015b), paragraph 65
181 OECD (2015a)
182 OECD (2015a)
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.”

The beginning of this exception is worded the same as the 2010 version, however, the end has shifted from “practically impeded the tax administration from determining an appropriate transfer price” to “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.” This change places more focus on the commercial rationality of the transaction and arguably the commentary in Chapter IX dealing with business restructures is also relevant in determining if a transaction is commercially rational.

The 2015 Guidelines also develop the original 2010 Guidelines example of a sale of the unlimited rights to all future intangibles arising from the next 20 years’ research and development activities for a lump sum. The conclusion of this additional analysis is that the transaction is commercially irrational for both parties as neither have a reliable means to determine an appropriate valuation. Therefore, the arrangement should be modified for the purposes of transfer pricing analysis. The replacement structure could be the provision of financing by the purchasing entity, the provision of research services by the R&D entity or if a specific intangible can be identified, a license of that intangible with contingent payment terms.

There are at least two problems with this “commercially realistically available” options approach. The first is that the functional profile of the related parties is the result of historical decisions of the MNE. In the example of a research and development services subsidiary, the MNE can structure this entity with limited financial resources and employment of personnel who do not have the capability or responsibility to make the decisions which control risk. The example given is unrealistic and does not provide much guidance. If a MNE group wanted to centralise its intangible assets, instead of entering into the transaction as described, it would have already entered into a contract research and

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183 OECD (2015a), paragraph 1.122
184 OECD (2010, 22 July), paragraph 1.65
185 OECD (2015a), paragraph 1.122
186 See in particular paragraphs 9.59 to 9.64 OECD (2010, 22 July)
187 OECD (2015a), paragraph 1.128
188 OECD (2010, 22 July), paragraph 1.65
development arrangement, which is in fact one of the possible alternatives given by the example.

In terms of a limited distribution arrangement, the historical functional allocation has been determined by the MNE. For example, the distribution agreement is probably non-exclusive and terminable at will. However, the historical conduct of the parties may suggest that the distribution entity has invested in higher levels of marketing spend representative of activities of a distributor that holds an exclusive and long term distribution agreement. This leads to the second problem, being that disproving the commercially realistic options available to related parties is practically very difficult. It often requires an historical analysis of all the transactions that have occurred up until this point in time, including for example, an historical analysis of the level of advertising and marketing spend since the distribution agreement was entered into. Second, it requires a detailed understanding of the commercial environment. In this arena, the taxpayer will always benefit from information asymmetry and access to its own industry experts, i.e. its employees.

Therefore, while this change has opened the door for a more robust analysis of the commercial rationality of the arrangements it still poses considerable hurdles before non-recognition is allowed. This is added to by the retention, and in some cases expansion, of language which emphasises that the tax authority must not arbitrarily disregard the transaction including noting of “the mere fact the transaction may not be seen between independent parties does not mean that it should not be recognised.”

5.3 Safeguard 3: Hard to value intangibles

As outlined in section 3.3 when intangible assets are transferred between related parties there are two issues that contribute to them being undervalued. The first being valuation of intangibles is often highly uncertain and the second that only separately identifiable intangible assets are recognised. The first is impacted by the new approach to hard-to-value intangibles, which is explained further below. The second is impacted by the 2015 Guidelines Chapter VI being the rewritten chapter on Intangible Assets. This is explored in Section 5.4 in the section on the profit split method.

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189 This statement is made twice in both paragraphs 1.122 and 1.123 of OECD (2015a)
190 OECD (2015a)
The general commentary around the issues associated with intangible assets with a highly uncertain value has not materially changed. However, the 2015 Guidelines have introduced a new approach for hard-to-value intangibles (“HTVI”).\textsuperscript{191} This section explains that where a HTVI has been transferred information asymmetry between taxpayers and tax administrations, including what information the taxpayer took into account at the time of the transfer, makes it very difficult for tax administrations to verify if the price was arm’s length.

The new approach allows for tax administrators to “consider \textit{ex post} outcomes as presumptive evidence about the appropriateness of the \textit{ex ante} pricing arrangements”\textsuperscript{192} if this is considered necessary in order to assess the reliability of the information on which the \textit{ex ante} pricing has been based. The tax administrator is then allowed to use the \textit{ex post} evidence to inform the determination of the arm’s length pricing arrangements, importantly including any contingent pricing arrangements, that independent parties would have considered at the time of entering the transaction. That is, if \textit{ex post} outcomes point to issues that would have been considered at the time of pricing the original transaction, price adjustments can be made based on what independent parties would have considered at the time of entering the transaction.

This approach is not available to tax administrations if any of the following four exemptions apply:

\begin{itemize}
  \item[i.] the taxpayer can illustrate the \textit{ex ante} price was based on an appropriate consideration of “reasonably foreseeable events and other risks, and the probability of occurrence”\textsuperscript{193} at the time the transaction was entered into and reliable evidence that any significant difference between the projections and actual outcomes was due to unforeseeable or unanticipated developments and that the probabilities were not significantly over or under estimated;
  \item[ii.] the HTVI transfer is covered by a bi or multilateral advance pricing arrangement;
  \item[iii.] the difference is not more than 20% of the compensation; or
  \item[iv.] a commercialisation period of 5 years has passed following the year in which the HTVI first generated unrelated party revenues and any differences were not more than 20%.
\end{itemize}

\textsuperscript{191} OECD (2015a), Chapter VI, Section D.4., paragraphs 6.186 to 6.195
\textsuperscript{192} OECD (2015a), paragraph 6.192
\textsuperscript{193} OECD (2015a), paragraph 6.193
This solution is not perfect as it stops short of allowing an adjustment based on *ex post* information and tax administrations will still suffer from information asymmetry. However, it at least gives the tax authority some grounds to consider *ex post* information when assessing the appropriateness of the price. Further, it places more evidentiary burden onto taxpayers and this in itself, should improve the level of analysis and in due course, compensation that occurs.

5.4 Safeguard 4: Profit split method

As outlined in Sections 2.3.3, 3.7 and 4.6, where the profit split method is applied it is more likely each contributing party will be allocated a portion of residual or non-routine profit and hence a portion of the MNE economic rent. However, the profit split method may only be applied if it can be illustrated that the MNE operations are highly integrated or more than one legal entity makes a unique contribution, generally seen as more than one legal entity having ownership or making contributions to intangible assets. As outlined in Section 4.6, given the nature of MNEs and the way they operate, proving a MNE has a high level of integration may be achievable. However, the question then becomes how the residual profit should be split and it will be important to consider whether the operational subsidiaries own or at least contribute to, the intangible assets of the group. The second condition for the profit split method to apply also relies on the identification of intangible assets therefore it is important to consider the definition and criteria for recognition of intangible assets. The identification of intangible assets is covered in the rewritten Chapter VI on intangible assets. This commentary is analysed below and also covers consideration of the new commentary on goodwill and hollow asset ownership included in Chapter VI. There is also additional commentary around assets that are potentially created by virtue of operating as a MNE and this commentary is covered in Section 5.5 which deals with the changes to the commentary around MNE economic rent. Finally, there is new commentary and further work suggested for when the profit split method should be used and this is analysed in Section 5.4.4 below.

5.4.1 Definition of intangible asset

The overriding consideration at the beginning of the rewritten Chapter VI on intangible assets "is whether a transaction conveys economic value from one associated enterprise to another...[and]...to the extent that an item conveys economic value, it should be taken into
account in the determination of arm’s length prices whether or not it constitutes an intangible”. It goes on to state that it is “especially important to ground the comparability and functional analysis on an understanding of the MNE’s global business and the manner in which intangibles are used by the MNE to add or create value across the entire supply chain”. These statements positively recognise that any activities in which the local entity engages in and which contribute to value chain profitability should be rewarded, even if they cannot be separately identified as an intangible.

However, the effect of these statements may be limited as the first section of the rewritten Chapter VI also notes an intangible asset must be “capable of being owned or controlled for use in commercial activities”. Further, “it is important to identify the relevant intangibles with specificity” and “it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm’s length prices or other conditions”.

A limitation of the “capable of control” and “identify with specificity” requirements is they do not sit easily with the underlying characteristics of intangible assets as outlined in section 4.3. These characteristics include that not all intangible assets are separably identifiable and saleable. They have an interconnectedness, causal ambiguity and ability to be impacted by their environment which is difficult to quantify and impossible to predict. How the various separate legal entities of a MNE interact to contribute, enhance and exploit a firm’s bundle of intangible assets is very difficult to determine. Further, a MNE operating as a whole creates more intangible assets, and enables greater economic rent from the intangible assets it owns than intangible assets taken separably out of the business.

In effect, the interaction of “capable of control” and “identify with specificity” with the characteristics of intangible assets, means that some of the intangible assets owned by a MNE are not easily categorised for the purposes of a transfer pricing analysis.

The revised guidance also link the allocation of risk in relation to intangible assets to the risk framework developed in the revised section D.1. of Chapter 1. This is important because if risk cannot be separated from the performance of functions, i.e. research and development, then the MNE subsidiary performing the research and development functions

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194 OECD (2015a), paragraph 6.2
195 OECD (2015a), paragraph 6.3
196 OECD (2015a), paragraph 6.6
197 OECD (2015a), paragraph 6.12
198 OECD (2015a)
would bear the risk of development and would therefore own the intangible asset for transfer pricing purposes. However, as discussed in section 5.1.1 above, the new 6 risk steps have limited impact as they still allow for separation of functions and risks. Therefore, the owner of the intangible asset can still outsource research and development functions. All that is required is for the intangible asset owner to perform the “special important functions”. Therefore, the ability of a MNE to centralise intangible asset ownership, while outsourcing the research and development activities to other MNE subsidiaries, has been retained.

5.4.2 Commentary on Goodwill

As outlined in Section 3.1.2 one impact of the requirement of intangible assets to be separately identifiable is that when there is a transfer of intangible assets to a centralised intangible asset owner unless the complete business is transferred, it is only the separately identifiable intangible assets that are valued. However, in the centralised intangible asset model all of the residual profit generated from the sale of products is allocated to the Intangible Asset Owner. The result is that prima facie the Intangible Asset Owner is allocated all the profit that is generated from the non-separately identifiable intangibles assets for transfer pricing purposes. This is the case even though the “goodwill” to which these intangible assets attach has not been transferred to the Intangible Asset Owner. This is another area where the 2015 Guidelines have bolstered the safeguards available.

The 2015 Guidelines have added a section which specifically addresses the issue of “goodwill and ongoing concern value”\(^{199}\) of the MNE. This new section outlines that “when the reputational value sometimes referred to by the term goodwill is transferred to or shared with an associated enterprise in connection with a transfer or licence of a trademark or other intangible that reputational value should be taken into account in determining appropriate compensation.”\(^{200}\) Further, the Annex to Chapter VI\(^{201}\) includes four examples that are particularly relevant to this issue.\(^{202}\)

Importantly, these examples acknowledge the interaction of goodwill and intangible asset value and note that in general goodwill value does not disappear simply due to an internal

\(^{199}\) OECD (2015a), Chapter VI, Section A.4.6, paragraphs 6.27 to 6.29

\(^{200}\) OECD (2015a), paragraph 6.28

\(^{201}\) OECD (2015a), Annex to Chapter VI, p. 117

\(^{202}\) The examples are 23, 26, 27 and 28 and they are analysed further in Annex I to this paper.
If there is a direct link between the intangible assets transferred and the future income stream, then the valuation or price on transfer of the intangible assets should take this into account, even if some of this value is represented as goodwill on the transferring entity’s balance sheet. Also, the value of the total business of the transferring entity can be used as a cross-check for the purported value of the transferred intangibles. Finally, one example provides that in some circumstances it “may be appropriate to value the transferred intangibles in the aggregate rather than to attempt a valuation on an asset by asset basis.” This is especially the case if the valuation of the whole business was significantly higher than the sum of the individually value intangible assets.

In general these examples are a move in the right direction as they recognise the potential for undervaluation of intangible assets and provide guidance for when careful analysis is required. These examples are however somewhat weakened by specific identification of intangible assets being the starting position and aggregation the exception. This is made clear in the last sentence of the section which states “the absence of a single precise definition of goodwill makes it essential for taxpayers and tax administrations to describe specifically relevant intangibles in connection with a transfer pricing analysis, and to consider whether independent enterprises would provide compensation for such intangibles in comparable circumstances.”

5.4.3 Hollow legal intangible asset ownership

As outlined in Section 5.1.2, the 2015 Guidelines provide that legal ownership by itself does not confer any right to retain the returns derived from exploiting the intangible. Where the legal owner performs no important functions in respect of the intangible asset and only contributes funding then the legal owner’s return will be restricted to either the risk-free rate of return, where the provider of the funds does not even have ability to exercise control over the financial risk associated with the investment, or the risk-adjusted rate of return where

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203 OECD (2015a), Annex to Chapter VI, paragraph 85
204 OECD (2015a), Annex to Chapter VI, paragraphs 85 and 96
205 OECD (2015a), Annex to Chapter VI, paragraphs 100 and 103
206 OECD (2015a), Annex to Chapter VI, paragraph 103
207 OECD (2015a), paragraph 6.29
208 OECD (2015a), paragraph 6.42
the entity does have the capability to exercise control in respect of the investment decision.\textsuperscript{209}

5.4.4 Application of the profit split method

The 2015 Guidelines note that the reliability of a one-sided analysis [such as the TNMM] is “substantially reduced if the party or parties performing significant portions of the important functions are treated as tested party or parties”.\textsuperscript{210} That is, if a MNE entity is performing an important function, then a target gross or net operating margin using the resale minus or the TNMM is unlikely to be appropriate. This implies the profit split method, incorporating an allocation of residual profit to all entities performing important functions, is more likely to be the most appropriate method. Having said that, both the introductory comments to the intangible assets chapter and the guidance for further work on the profit split method make it clear the profit split method should not be used as an automatic default method. It must be illustrated that independent party remuneration of the important functions would include a profit sharing element. The guidance for further work on the profit split method even goes as far to say that “an appropriate method using inexact comparables is likely to be more reliable in such cases [where a share of the profits does not represent an arm’s length outcome] than an inappropriate use of the profit split method\textsuperscript{211} and that “integration alone may be insufficient to warrant the use of such a method [the profit split method].”\textsuperscript{212} This, combined with the commentary which allows for the allocation of risk to the guiding or directing mind, may mean the general comments about the inappropriateness of one-sided analysis will have limited effect.

However, the 2015 Guidelines also note later in Chapter VI that “focusing on only one side of a transaction generally does not provide a sufficient basis for evaluating a transaction involving intangibles (including in those situations for which a one-sided transfer pricing method is ultimately determined).”\textsuperscript{213} Therefore as noted in section 5.1 MNEs will probably need to make some changes on the ground, as tax authorities are now more likely to examine whether the non-tested party, i.e. the Intangible Asset Owner, has the required

\begin{footnotes}
\footnote{209}{See OECD (2015a), paragraph 1.103 and page 64 for risk-free return commentary and paragraph 6.61 in respect of risk-adjusted return.}
\footnote{210}{OECD (2015a), paragraph 6.58}
\footnote{211}{OECD (2015a), page 60}
\footnote{212}{OECD (2015a), page 58}
\footnote{213}{OECD (2015a), paragraph 6.112}
\end{footnotes}
capability and financial capacity to be allocated the risk and residual profit associated with the intangible asset.

5.5 Safeguard 5: MNE economic rent

The author argues in this paper that MNE economic rent (fully described and explained in Section 4 above) is a critically important matter that has been inadequately addressed to date in transfer pricing guidelines. This has, in transfer pricing assessments, resulted in an excessive allocation of “residual” profit to an entity such as the Intangible Asset Owner (in the centralised asset model discussed above), which will inevitably be in a low tax jurisdiction.

This is an area where there has been prima facie revision and addition to the OECD commentary in the 2015 Guidelines. There is a new section which deals with MNE group synergies which includes examples on incidental group benefits and a discussion of volume discounts. MNE group synergies are also mentioned in the section outlining further work on the profit split method. Commentary on location savings has also been included in Chapter I, in addition to the existing commentary sitting within the business restructure Chapter IX and it has been expanded to include a section on other local market features and a new section on assembled workforce. As noted above, Chapter VI on transfer pricing aspects of intangible assets has also been significantly rewritten.

The impact of the revised sections on the transfer pricing treatment of MNE economic rent is analysed below. While this section in general follows the same categories as analysed in Section 4.7, there are some changes and additional headings due to the new sections added by the 2015 Guidelines.

5.5.1 Safeguards 5.1 and 5.2: MNE group synergies, incidental group benefits & volume discounts

The 2015 Guidelines identify that in some circumstances benefits can arise to MNEs that are not generally available to independent entities. These benefits may arise "as a result of

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214 OECD (2015a), Chapter I, Section D.8., paragraphs 1.157 to 1.173
215 OECD (2015a), Chapter I, Section D.7., paragraphs 1.152 to 1.156
216 OECD (2015a), pages 55-61. This work is being done by Working Party 6 during 2016, with a discussion paper issued, OECD (2016) and a final report planned to be issued in the first half of 2017.
217 OECD (2015a), Chapter I, Section D.6.1, paragraphs 1.140 to 1.151
218 OECD (2010, 22 July), Chapter IX, Section E, paragraphs 9.148 to 9.153
219 OECD (2015a), Chapter I, Section D.6.2., paragraphs 1.144 to 1.151
220 OECD (2015a), Chapter I, Section D.7, paragraphs 1.152 to 1.156
221 OECD (2010, 22 July) and OECD (2015a)
combined purchasing power or economies of scale, combined or integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors”.\textsuperscript{222} The definition of incidental benefit is in line with the 2010 Guidelines\textsuperscript{223} and is defined as “benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit.”\textsuperscript{224}

The commentary goes onto state that “incidental” does not necessarily mean “small or relatively insignificant”. Therefore, one must assume it has been considered that some of these incidental benefits may be material in dollar terms. There is also reference in other sections of the revised guidelines that seem to recognise MNE economic rents exist and may be valuable. For example, in Chapter I, Section D.1., which deals with identifying the commercial or financial relations between related parties, the functional analysis is referred to as including an analysis of “how those functions relate to the wider generation of value by the MNE group to which the parties belong.”\textsuperscript{225} This can be contrasted to the corresponding section of the 2010 Guidelines\textsuperscript{226} which states that “for this purpose, it may be helpful to understand the structure and organisation of the group and how they influence the context in which the taxpayer operates.” This is arguably a much weaker statement regarding the value each related party contributes to MNE economic rent.

Yet, unfortunately in spite of the increased recognition of MNE economic rent in the 2015 Guidelines,\textsuperscript{227} they ultimately reach the same conclusion as to its treatment as the 2010 Guidelines.\textsuperscript{228} That is, if synergistic benefits arise merely as a result of membership of the MNE group with no deliberate action being taken, the synergistic benefits do not need to be charged for, or allocated to, the MNE entities that benefit from, or contribute to, the MNE economic rent. Comparability adjustments, a charge or allocation of benefits are only required if there is deliberate action which gives rise or access to a benefit. Therefore, group members will not be allocated any of the benefits from MNE economic rent unless it is considered that the group member has undertaken a deliberate action in respect of creating the MNE economic rent.

\textsuperscript{222} OECD (2015a), paragraph 1.157
\textsuperscript{223} OECD (2010, 22 July), paragraph 7.13
\textsuperscript{224} OECD (2015a), paragraph 1.158
\textsuperscript{225} OECD (2015a), paragraph 1.36
\textsuperscript{226} (OECD, 2010, 22 July), paragraph 1.42
\textsuperscript{227} OECD (2015a), paragraphs 1.158 to 1.159
\textsuperscript{228} OECD (2010, 22 July), paragraph 7.13
As outlined in Section 4.7.1, where a subsidiary of a group has been able to access decreased costs merely due to being a member of the MNE group and not due to any deliberate action, these decreased costs can be retained by the subsidiary. The two main areas in which this occurs are first decreased interest costs and guarantee fees and second centralised purchasing and volume discounts. The 2015 Guidelines give various examples for each of these costs. While these examples are more detailed than those given in the 2010 Guidelines, they draw the same conclusions in line with the general principle outlined above. Therefore, where parental affiliation results in lower interest costs to the subsidiary, the subsidiary is permitted to access some of the MNE economic rent. Where there is a co-ordinated or centralised purchasing function, the savings from this concerted effort are allocated to each of the participating group members. However, if the group members utilise the TNMM and target a net operating margin, any such savings will be ultimately allocated back to the centralised Intangible Asset Owner.

5.5.2 Safeguard 5.3: Location savings, other local market features and assembled workforce

5.5.2.1 Location savings

The 2015 Guidelines contain a new section229 dealing with location savings which refers to the existing commentary on location savings in the business restructures chapter230 and outlines that this commentary applies to broader circumstances as well. As such, the existing commentary has been adopted more broadly and there has been no change in approach.

5.5.2.2 Other local market features

A new section231 has also been added on local market features where such features impact prices and margins earned by entities operating in the market. These features include factors such as purchasing power and preferences of households, relative availability of local country infrastructure, proximity to profitable markets and availability of a trained and educated workforce.

The 2015 commentary concludes that any increased market profitability of the MNE in a particular jurisdiction should be reflected by the comparability analysis. Comparable local independent entities should also be more profitable and this will be reflected in any

229 OECD (2015a). Chapter I, Section D.6.1., paragraphs 1.140 to 1.143
231 OECD 2015, Chapter I, Section D.6.2., paragraphs 1.144 to 1.151
benchmarking analysis. For the centralised intangible asset model this will mean the operational entities should receive a higher net margin if local comparables are obtaining relatively higher profitability.

There are two areas where this approach has some limitations. First, due to the lack of comparable data (as explained in section 3.4), the local comparables available may not be in exactly the same industry segment as the MNE entity. Further local market features may impact the profitability of the MNE entity differently than they do the comparable entities. The guidelines would require comparability adjustments to be made but quantifying any such adjustments is difficult. The second and related issue is that because intra-group functional profiles are generally respected, the local operational entity is likely to have a limited risk profile. This may make it difficult to argue that in an independent party situation the MNE subsidiary would exert sufficient bargaining power to retain any of the increased profitability due to local market factors. It is always much easier to assert that in an independent party negotiation the owner of the intangible assets will have much higher bargaining power and will therefore be able to demand a larger share, if not all, of the market premium.

Finally, the guidelines make it very clear that local market features are not intangible assets as they are not owned or controlled by the local MNE entity. As such, the possibility of the local entity having intangible assets in order to increase its bargaining power and/or enliven the use of the profit split method is limited.

5.5.2.3 Assembled workforce

A new section\textsuperscript{232} has also been added to address the impact of an assembled workforce. In summary, this section requires the value contributed by an assembled workforce to be taken into account by way of comparability analysis and adjustments. While not specifically addressed, the commentary implies that an assembled workforce in and of itself is unlikely to constitute an intangible asset.

5.6 Conclusion: Impact of 2015 Guidelines

Overall, the 2015 Guidelines now include much more guidance aimed at ensuring the transfer pricing analysis is based on the substance of the arrangements, or in 2015 Guideline terms, the accurately delineated transaction. Ultimately this will mean that MNE

\textsuperscript{232} OECD (2015a), Chapter I, Section D.7., paragraphs 1.152 to 1.156

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entities which purport to fund and own the rights to exploit intangible assets will need to have the financial capacity to do so along with senior employees who are capable of, and actually make the decisions to take on risk and direct, monitor and modify the activities performed. So-called intangible asset “cash boxes” will be limited to receiving the risk-free rate of return, where the provider of the funds does not even have ability to exercise control over the financial risk associated with the investment, or the risk-adjusted rate of return where the entity does have the capability to exercise control in respect of the investment decision. Also, the ability to obtain Patent Box concessional rates will be limited to the proportion of expenses that are actually incurred in the relevant jurisdiction (although grandfathering applies until 30 June 2021 and some concessions, including a 30 percent uplift, and allocation opportunities are likely to still make Patent Box regimes attractive).

As such, the safeguard of pricing the substance of the transaction has been significantly bolstered. However, there are still areas in the 2015 Guidelines that allow for the outsourcing of activities by the entity that takes on risks. So, in respect of intangible assets, the MNE subsidiary that funds the intangible asset will still be able to outsource the development, exploitation, maintenance, protection and exploitation activities related to the intangible asset as long as it employs personnel capable of directing these activities. This effectively allows for continued separation of functions from risk and asset ownership, therefore allowing the centralised intangible asset model to remain largely effective.

In the area of intangible assets, the new approach for hard to value intangibles should increase the level of analysis performed by MNE’s at the time of transfer of any intangible assets in order to stave off giving tax authorities more scope to review the valuation of an intangible asset using ex post information. Further, the 2015 Guidelines now more fully recognise the impact of goodwill on intangible asset transfers and provide a number of examples which recognise the potential for undervaluation of intangible assets and provide guidance for when careful analysis is required. These examples are however weakened by specific identification of intangible assets being the starting position and aggregation the exception.

The requirement for intangible assets to be capable of control and specifically identifiable also means that the potential application of the profit split method is limited with the consequence that MNE economic rent will largely remain allocated to the centralised intangible asset owner in the group. Further, the additional commentary on MNE group
synergies, location savings and other local market features and assembled workforce have also not changed the allocation of MNE economic rent. As such, the allocation of MNE economic rent will continue to be limited to situations where parental affiliation leads to decreased interest costs, co-ordinated efforts obtain volume discounts or where “deliberate concerted actions or transactions leading to...[the synergistic]...benefit”\(^{233}\) have taken place. Apart from noting that deliberate concerted action may take place without the existence of a written contract between the related parties\(^ {234}\), there is virtually no discussion of what constitutes “deliberate concerted actions”. Importantly, where the line between passive participation in an integrated MNE group versus “deliberate action” or integration resulting in each party making a “unique and valuable” contribution sits has yet to be addressed.

BEPS Action Item 8 to 10 final report outlines that there is further work to be done on the application of the profit split method\(^ {235}\) and there is the possibility that this further work may re-examine the application of the profit split method with regard to MNE economic rent. First, the comments detailing the further work refer to the expected use of the profit split method if synergistic benefits arise from deliberate action. Second, the comments explain that the existence of integrated business models may mean the profit split will be the most appropriate method. However, the discussion also issues stern warnings for when the profit split method can be used. It notes “integration alone may be insufficient to warrant the use of”\(^ {236}\) the profit split method. Further, if the delineated transaction (including the risk allocation) indicates that pricing by independent parties would not include a share of profits, then inexact comparables are preferable to applying the profit split method. Therefore, the initial impression is the bar for applying the profit split method will be kept high in order to avoid a default to profit split method in the absence of comparable data.

As outlined in Section 5, the 2015 Guidelines have made many positive changes to the practical application of the arm’s length principle. However, the 2015 Guidelines have not substantially altered the treatment of MNE economic rent and therefore the effectiveness of the centralised intangible asset model with risk and asset ownership still being able to be separated from functions still results in MNE economic rent being largely overlooked with

\(^{233}\) OECD (2015a), paragraph 1.158
\(^{234}\) OECD (2015a), paragraph 1.49
\(^{235}\) OECD (2015a), pp. 55 to 61
\(^{236}\) OECD (2015a), page 58, paragraph 8
the end result of it being fully allocated to the intangible asset owner, who is only required to employ enough senior personnel to direct the outsourced activities.

The impact of the 2015 Guidelines on the safeguards to the arm’s length principle are summarised in Table 3. For completeness this table also summarises the position under the 2010 Guidelines and Australia’s new transfer pricing provisions for separate legal entities (Sub-division 815B of the 1997 Income Tax Assessment Act). Finally, the table also summaries the practical gaps that, in the author’s view still exist and the areas where the 2015 Guidelines include commentary which limit the impact of the safeguards.
Table 3: Impact of 2010, Subdivision 815B and 2015 Guidelines on safeguards of the arm's length principle
<table>
<thead>
<tr>
<th>Safeguard</th>
<th>Substance</th>
<th>Reconstruction</th>
<th>Profit Split Method &amp; Hard to Value Intangibles</th>
<th>MNE Economic Rent</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2010</strong></td>
<td>Price substance over form</td>
<td>Independent enterprises behaving in a commercially rational manner would have acted differently and the actual structure practically impedes the tax administration from determining an appropriate transfer price (2010 Guidelines paragraph 1.65)</td>
<td>Intangible assets need to be separately identifiable</td>
<td>Business needs to be highly integrated</td>
</tr>
<tr>
<td><strong>815B</strong></td>
<td>Codified substance test (815-130(1))</td>
<td>Codified: entities dealing wholly independently in comparable circumstances would not have entered into the transaction (815-130(2)-(4))</td>
<td>Consistency with 2010 OECD guidelines (815-135)</td>
<td>Consistency with 2010 OECD guidelines (815-135)</td>
</tr>
</tbody>
</table>

### 2015
- Actual delineated transaction
- 6 risk steps
- Definition of risk management
- Financial capacity to take on risk
- End of “cash boxes”
- Nexus test for patent box regimes
- Goodwill examples

Independent enterprises behaving in a commercially rational manner would have acted differently, 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 (2015 Guidelines paragraph 1.122)

- Development, enhancement, maintenance, protection and exploitation of intangible assets all examined
- Actual delineated transaction, end of cash boxes, nexus test for patent box regimes and goodwill examples
- Hard to value intangibles
- One-sided analysis may not be appropriate
- Further work to come

### Practical Gaps
- High evidentiary burden
- Likely only extremely artificial intra-group legal form transactions are pursued

Options realistically available are based on historical profile of the related party entity
- Taxpayer/tax authority information asymmetry
- Likely only extremely artificial intra-group structures are tackled
- Tax administrations need to postulate how taxpayer would have structured intra-group legal transactions and business model

- High evidentiary burden
- Lack of guidance on how to apply the method (further work to be done)

### MNE Economic Rent
- Recognise its existence (paragraphs 1.10 and 9.4)
- No widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises

![DRAFT – Please do not quote without permission of the author](83)
| 2015 Gaps | Fragmentation and central guiding minds (paragraphs 1.65, 6.51 & 6.56) | Definition of intangible assets: Capable of control, separately identifiable and identify with specificity and care with marketing intangibles (paragraphs 6.6 and 6.12) | Fragmentation and central guiding minds (paragraphs 1.65, 6.51 & 6.56) | Definition of intangible assets | Definition of intangible assets | Deliberate concerted action not defined | Definition of intangible assets | Narrowing of the quantum, extent and impact of MNE group synergies |

- Owner of the intangible assets can still outsource functions and risk mitigation (i.e. fragmentation of functions, assets and risks)
- Central guiding minds
- Paragraphs 1.65, 6.51 & 6.56

- Definition of intangible assets: Capable of control, separately identifiable and identify with specificity and care with marketing intangibles (paragraphs 6.6 and 6.12)
- Fragmentation and central guiding minds (paragraphs 1.65, 6.51 & 6.56)

- Integration alone may not be sufficient to warrant the use of profit split method (page 58)
- Deliberate concerted action not defined
- Definition of intangible assets
- Narrowing of the quantum, extent and impact of MNE group synergies
At this point it is also worthwhile revisiting the limitations of the arm’s length principle and considering the practical gaps as well as the concerns identified with the 2015 Guidelines. Finally the residual conceptual gaps are also summarised in Table 4.

**Table 4: Impact of 2015 Guidelines on arm’s length principle limitations**

<table>
<thead>
<tr>
<th>Limitation</th>
<th>Practical Gap</th>
<th>2015 Guideline Concerns</th>
<th>Conceptual Gap</th>
</tr>
</thead>
</table>
| L1: Recognition on related party contracts | - High evidentiary burden  
- Likely only extremely artificial intra-group legal form transactions are pursued  
- Options realistically available are based on historic profile of the related party entity  
- Taxpayer/tax authority information asymmetry  
- Tax authority needs to postulate how taxpayer would have structured intra-group legal transactions and business model | - Owner of the intangible assets can still outsource functions and risk mitigation (i.e. fragmentation of functions, assets and risks)  
- Central guiding minds  
- Paragraphs 1.65, 6.51 & 6.56 | |
| L2: Lack of comparable data | - High evidentiary burden  
- Lack of guidance on how to apply profit split method (further work to be done) | - Lack of recognition that comparables do not include MNE economic rent | - Lack of recognition that comparables do not include MNE economic rent  
- Operating as an MNE provides greater access to intangible assets and may in and of itself create other intangible assets, some of which are not separately identifiable or saleable  
- Fragmentation and central guiding minds |
| L3: Identification and price of intangible assets | - High evidentiary burden  
- Lack of guidance on how to apply profit split method (further work to be done) | - Definition of intangible assets: capable of control, separately identifiable and identify with specificity and care with marketing intangibles (paragraphs 6.6 and 6.12)  
- Fragmentation and central guiding minds (paragraphs 1.65, 6.51 & 6.56) | |
| L4: MNE economic rent | - High evidentiary burden  
- Need to prove deliberate concerted action  
- Difficult to measure | - Deliberate concerted action not defined  
- Narrowing of the quantum, extent and impact of MNE group synergies  
- Definition of intangible assets (paragraphs 6.6 and 6.12)  
- Integration alone may not be sufficient to warrant the use of the profit split method (2015 Guidelines, page 58) | - Operating as a MNE provides greater access to intangibles assets and may in and of itself create other intangible assets and that each MNE subsidiary contributes to this to varying degrees |
6. A modified approach to the arm’s length principle

The academic literature has also been reviewed to investigate proposed solutions to the limitations of the arm’s length principle. These solutions fall into two main categories: global formulary apportionment and modifications to the arm’s length principle. Appendix II provides a brief summary of the commentary suggesting global formulary apportionment, including some variations of this model. Appendix III gives a brief summary of other approaches to modifying the arm’s length principle.

The author considers that a modified application of the arm’s length principle is the approach that best allocates profit to where value is created. This section therefore proposes a version of a modified approach to the arm’s length principle, referred to as the identical twin approach and considers whether this approach deals with the conceptual gaps identified in the table above. The identical twin approach draws on the various suggestions outlined in Appendix III, including the changes suggested to the existing 2010 Guidelines as outlined by Vann237 and a modified application of the profit split method as outlined by Avi-Yonah238, but frames the approach differently to place it more in line with the existing 2010 and 2015 Guidelines239 and to allow it to fully address the allocation of MNE economic rent. This section also considers the impact of Australia’s recent Chevron240 decision and Australia’s new transfer pricing laws.241

6.1 Identical twin approach

Section 4 of this paper has noted that a MNE’s profitability is derived from three main sources: the risk-free return; a return for risk and finally a return of economic rents. The economic rent of a MNE is in turn from three sources: general economic rent, greater access to the factors that generate general rent due to operating as a MNE and finally MNE economic rent. The factors that contribute to economic rent are different for each industry and in fact change over time for particular industries, segments and in some cases individual MNE groups, or taxpayers.242 Vann243 notes “the premise of much of the recent

237 Vann (2010)
238 Avi-Yonah (2010)
239 OECD (2010, 22 July) and OECD (2015a)
240 “Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (no 4)” 2015)  
241 This is one of the main reasons a global formulary approach is limited in its ability to find one formula that will appropriately allocate profits to where value is created.
242 Vann (2014), page 439
transfer-pricing work at the OECD has been that all of the return earned by a corporation is from risk taking...Once it is recognized that managing risk is only one of the contributors to corporate profit, and often not the major one, it becomes possible to reconfigure the transfer-pricing rules away from the tax-avoidance engine that they have become.” The author agrees with this view and considers that a solution which deals with all three aspects of economic rent is needed in order to ensure profit is allocated to where value is created.

How should this be done? The author considers the easiest way is to reframe the arm’s length principle in terms of its application. The current opening statement in the 2010 Guidelines, which has not been amended by the 2015 Guidelines, states that Article 9 is applied:

“By seeking to adjust profits by reference to the conditions which would have ...[been]...obtained between independent enterprises in comparable transactions and comparable circumstances (i.e. in “comparable uncontrolled transactions”), the arm’s length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business.”

One interpretation of this statement is that each MNE subsidiary is treated as if it is not part of a MNE at all and that it is operating as if it was an independent party, orphaned from the group. This interpretation is supported by the words “rather than as inseparable parts of a single unified business” and treats both sides of the transaction as occurring between two independent entities, each of whom is operating as an independent entity.

An alternative approach, and the one which has been followed in Australia’s recent Chevron case (refer Section 6.1.2) would be to treat the dealing as between two independent entities, but recognising that each entity is still part of a MNE group and brings with it the characteristics of a unique contribution to the overall value chain. This is sometimes referred to as the “identical twin” approach as opposed to the “orphan” approach. That is, the dealing is between the MNE subsidiary with its same characteristics (as a MNE subsidiary, i.e. an identical twin) and the related party, with the related party dealing priced as if it was priced with an independent party. Langbein framed this

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244 OECD (2010, 22 July), paragraph 1.6
245 “Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (no 4)” 2015

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approach as “an impartial manager deciding the relative contributions to overall profits of the component parts of his enterprise.”

This approach would mean that when analysing the dealings between a MNE subsidiary and other parts of the MNE group, one would take into account the value contributed by the MNE subsidiary, including the value it brings simply because it is a part of the MNE group. This would include a consideration of all the elements outlined in Table 1 in Section 4.4. The change in approach is subtle but important and best illustrated by way of example.

By reference to the centralised intangible asset model, the contract R&D provider brings with it many benefits including lower transaction costs (the Intangible Asset Owner does not need to search for external parties to perform the research and development contract, it does not need to negotiate the terms of the agreement, nor does it need to monitor compliance with the agreement and negotiate enforcement action etc.), no intangible asset hold up investment risk, largely reduced asset dissipation risk, implicit agreement to employ personnel in line with the MNE culture and values etc. This contrasts with the orphan approach which treats the R&D contractor as being a separate entity entirely independent from the MNE group with none of these benefits being considered as part of the transfer pricing analysis. This can result in the contribution of the R&D subsidiary being undervalued. This same analysis applies for the other operational subsidiaries as well, i.e. the Manufacturer, Regional Hub and Marketer/Distributor.

Another way of considering this is pointed out by Vann\textsuperscript{247} and involves acknowledging that the related party contract entered into is actually incomplete. Continuing the contract R&D example, instead of the related party contract being for just research and development services, it is in fact much more than that. It is a contract for the provision of research and development activities in the context of a fully integrated environment, with complete disclosure of activities, seamless information flow, integrated decision making and full access and protection of any of the outcomes of the research. It can be argued this is very different from a contract/arrangement that would have been entered into between two independent parties and therefore the comparables often cited by taxpayers of an independent party contract R&D arrangement are inappropriate.

\textsuperscript{246} Langbein (1986)  
\textsuperscript{247} Vann (2010), p. 323
The identical twin approach recognises the contribution each MNE subsidiary makes to the ability of the MNE to generate and access economic rent. It also directly considers the MNE economic rent that is accessed and created purely because the entity is operating as a MNE. The identical twin approach therefore overcomes not only the residual conceptual gaps outlined in the above table, but also the 2015 Guideline concerns. This is because the analysis of the contribution of each MNE subsidiary would include consideration of all the contributions the MNE subsidiary makes, including to non-separately identifiable intangible assets and assets created purely because the MNE is operating as an MNE.

6.2 Support for the identical twin approach

6.2.1 Parental affiliation

The identical twin approach is already followed when determining the impact of parental affiliation on the pricing of loans. When assessing the credit rating of a borrowing entity which is part of a MNE group, instead of assessing its credit rating as if it was orphaned from the group, its credit rating is assessed taking into account its “membership in the”248 MNE group. If an independent entity would increase the MNE subsidiary’s credit rating because of this membership, then the increased credit rating is the basis for determining the arm’s length interest rate for any intra-group financial transactions the MNE subsidiary undertakes.

This treatment is supported by both the 2010 and 2015 Guidelines,249 with the later providing more detailed examples in which it states “because of S’s [the MNE subsidiary in MNE group “P”] membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating, i.e. a lower interest rate than would be charged if S were an independent entity with its same balance sheet.”250

This approach treats the MNE subsidiary as if it brought to the dealing all its attributes of being a group member, but it determines how the last leg of the dealing would be priced as if it were dealing with an independent entity, rather than a member of the MNE group.

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248 OECD (2015a), paragraph 1.164
250 OECD (2015a), paragraph 1.164
6.2.2 Chevron decision

An Australian Federal Court decision (single judge currently on appeal), Chevron, handed down in October 2015, which concerned a borrowing and interest rate transfer pricing assessment, also provides support for the above interpretation of the arm’s length principle in two respects.

First, when interpreting the loan transaction between the Australian subsidiary and its offshore related party, Justice Robertson makes a clear pronouncement on whether the orphan or identical twin approach should be adopted:

“One issue of statutory construction between the parties was whether s 136AA(3)(d) [of Australia’s Income Tax Assessment Act, 1936] required that the borrower as an independent party be considered as a stand-alone company. In my opinion, the answer is “no” as this would be to use the word “independent” as if it meant entirely independent rather than, in a case such as the present, independent of the lender.

For present purposes, it is useful to adopt the tool of analysis that, in the hypothetical, the hypothetical independent parties have the characteristics relevant to the pricing of the loan so as to enable the hypothesis to work. Thus, for example, the borrower will be an oil and gas exploration and production (E&P) subsidiary.”

Importantly, Justice Robertson stated that the entity in question will be treated as a “production subsidiary”, i.e. when determining an arm’s length price, the entity retains its character as a member of a MNE group.

The second way in which this judgement supports the identical twin approach is in respect of the interpretation of the actual transaction. The taxpayer argued that the transaction to be considered in the transfer pricing assessment was restricted to the provision of loan funds in return for the payment of interest at a set rate without the borrower providing any security or guarantees. Justice Robertson rejected this view and states:

“I do not accept the submission of the applicant that ‘property’ is to be read down or that ‘services’ is to be read down so as to refer, relevantly, only to an agreement for or in relation to the lending of moneys, given the non limiting characteristic of the examples in light of the words “without limiting the generality of the foregoing” in the definition of services in s136AA(1).”

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251 “Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (no 4)” 2015
252 “Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (no 4)” 2015, paragraphs 79 and 80
253 “Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (no 4)” 2015, paragraph 71
In effect, Justice Robertson rejected the taxpayer’s presentation of an incomplete contract and instead interpreted the arrangement as a full contract with all the attendant forms of consideration that could be provided by the borrower, including the terms such as security over assets and the inclusion of a guarantee from its parent.

While each of these points has been interpreted in the context of Australia’s old transfer pricing law, this decision illustrates the court’s approach to the interpretation of the arm’s length principle.

6.2.3 Australia’s New Transfer Pricing Law

Australia introduced new transfer pricing laws which are effective for income years commencing on or after 29 June 2013 and for separate entities are found in Subdivision 815B of the 1997 Income Tax Assessment Act.

Under Subdivision 815B an entity derives a transfer pricing benefit if, amongst other things, had “the arm’s length conditions operated, instead of the actual conditions...the amount of the entity’s taxable income for an income year would be greater.”\(^\text{254}\) The definition of arm’s length conditions is:

“arm’s length conditions in relation to conditions that operate between an entity and another entity, are the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances.”\(^\text{255}\) (emphasis added)

This wording interpreted by Justice Robertson from Subsection 136AA(3)(d) of the Income Tax Assessment Act 1936 is:

“a reference to the arm’s length consideration in respect of the acquisition of property is a reference to the consideration that might reasonably be expected to have been given or agreed to be given in respect of the acquisition if the property had been acquired under an agreement between independent parties dealing at arm’s length with each other in relation to the acquisition” (emphasis added)

While there are differences in wording, with the old law requiring “independent parties” “dealing at arm’s length” and the new law requiring “independent entities” “dealing wholly independently with one another”, the new law would still seem to allow for Justice

\(^{254}\) Subsection 815-120(1)(c) of the Income Tax Assessment Act 1997
\(^{255}\) Subsection 815-125(1) of Income Tax Assessment Act 1997
Robertson’s interpretation in that the independent entity would be assessed in comparable circumstances, i.e. as a subsidiary of the MNE group.

Further, in terms of the transaction to be priced, Subdivision 815B would appear to be broader than the old law in that it looks at the full arm’s length conditions in connection with the commercial and financial relations and not just the individual transaction. As such, Justice Robertson’s interpretation of the full contract, as opposed to the partial contract priced by the taxpayer, should also be available under the new provisions.

Finally, there are other aspects of the new law which lend themselves to the identical twin interpretation. This includes the object of the provision which is “to ensure that the amount brought to tax in Australia from cross-border conditions” reflects “the arm’s length contribution made by Australian operations through functions performed, assets used and risks assumed”\(^{256}\) and also the inclusion of the 5 comparability factors when identifying comparable circumstances.\(^{257}\)

### 6.2.4 2010 and 2015 Guidelines\(^ {258}\)

The identical twin approach is not inconsistent with the framework outlined by the 2010 and 2015 Guidelines. Vann\(^ {259}\) notes “the guidelines accept in many ways the modern approach to value creation in MNEs, especially through the functional analysis.” To explain further, the existing framework requires first an analysis of the actual delineated transaction. When this is performed each of the 5 comparability factors need to be addressed, the second of these being “the functions performed by each of the parties...including how these functions relate to the wider generation of value by the MNE group to which the parties belong [emphasis added].”\(^ {260}\) This is further elaborated noting that “it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation.”\(^ {261}\) In addition, the fourth comparability factor is also relevant as it includes an analysis of the economic circumstances of the parties and of the market in which the parties operate.

\(^{256}\) Subsection 815-105(1) of Income Tax Assessment Act 1997

\(^{257}\) Subsection 815-125(3) if Income Tax Assessment Act 1997

\(^{258}\) OECD (2010, 22 July) and OECD (2015a)

\(^{259}\) Vann (2003), p. 142

\(^{260}\) OECD (2015a), paragraph 1.36

\(^{261}\) OECD (2015a), paragraph 1.51
The result of these two comparability factors is an analysis of the drivers of economic rent in the taxpayer’s industry and consideration of how each MNE subsidiary contributes to the overall generation of profit for the MNE group.

Further, both sets of Guidelines draw on the concept of options realistically available to each of the parties.262 This implicitly requires the transfer pricing assessment to take into account the bargaining position of each of the entities to the transaction. In the centralised intangible asset model, with reference to the contract research and development arrangement between the Intangible Asset Owner and contract R&D subsidiary, what options did the Intangible Asset Owner have available in order to perform research and development functions? Arguably, the Intangible Asset Owner could have outsourced this function to an independent party. One reason it has chosen not to do so is because it wants to derive all the benefits associated with MNE economic rent. The factors contributing to this decision will be different for each industry. As noted in Section 4, for some industries where patent protection is weak or difficult to enforce, dealing with a related party is very important in order to protect the intangible asset therefore influencing the decision to operate by way of subsidiaries rather than independent parties.

If this analysis is followed through, the contract R&D subsidiary, as a member of the MNE group should be able to demand a premium over an independent contract research and developer as it presents a better option than is commercially realistically available to the Intangible Asset Owner.

6.3 Does anything need to change?

As outlined above, the existing guidelines and Australia’s transfer pricing law already provide for the identical twin approach to the arm’s length principle and this interpretation is already adopted when pricing intra-group loans. However, there does need to be an agreed conceptual shift to extend the identical twin approach to all transactions, not just the pricing of intra-group loans. Further, as illustrated by the analysis in Sections 4 and 5 the existing 2010 Guidelines263 and the proposed 2015 amendments,264 include other statements facilitating an approach which focuses on risk. The result is that under these Guidelines all economic rent (including general and MNE economic rent) is allocated to the

262 In OECD (2010, 22 July) see paragraphs 1.34 to 1.37; OECD (2015a) see paragraphs 1.38 to 1.40 and 1.52 to 1.55.
263 OECD (2010, 22 July)
264 OECD (2015a)
intangible asset owner. To be clear that the identical twin approach should be adopted, it would also be beneficial to amend the opening statement of the arm’s length principle in paragraph 1.6\(^{265}\) to remove the words “the arm’s length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business.”

The specific areas which need amendment to allow for easier interpretation when assessing the contribution each MNE subsidiary makes are considered briefly below.

**6.3.1 Separation of functions, assets and risks**

As highlighted by this paper, the continued allowance of the separation of risk and asset ownership from the underlying performance of functions means that most, if not all, of the economic rent (both general and MNE) is allocated to the MNE entity which employs the few high level decision makers. As illustrated by the analysis in Section 4, at the very least some of this rent is generated from operating as a MNE and accordingly, the few decision makers if acting in isolation would not have had access to this rent. Therefore, allocating all of this profit to these few employees and the entity that takes on the financial risk appears inappropriate.

The critical paragraphs which allow for this separation are paragraphs 1.62, 6.51 and 6.56 of the 2015 amendments.\(^{266}\) These paragraphs need to be amended to ensure appropriate recognition is given to the fact that each employee in a MNE contributes to the value created. While acknowledging that MNEs should be allowed to structure the ownership of their intangible assets in whichever way is commercially most efficient, when pricing the intercompany transactions, and in particular research and development activities, it must be recognised that a few employees deemed to be the “guiding minds” of the research and development activities do not generate all the profit associated with economic rent (both general and MNE).

**6.3.2 Intangible asset recognition**

As pointed out in Sections 4 and 5, intangible assets associated with a common culture, human resource assets, relationship investment and other aspects of a MNE operational

\(^{265}\) OECD (2010, 22 July)
\(^{266}\) OECD (2015a)
structure are highly unlikely to meet either the 2010 or 2015 Guideline’s\textsuperscript{267} requirements for recognition as intangible assets. In order to allow for all the contributions each MNE subsidiary makes to MNE group profit, the intangible asset recognition requirements need to be relaxed in this area to not only allow for intangible assets which are not separately identifiable but also to take into account those which are only created due to integration and operating as a MNE group. This amendment would also assist in a full understanding and appropriate pricing of any intangible asset transfers across jurisdictions.

6.3.3 MNE group synergies
The final area requiring amendment is the commentary on MNE group synergies. This commentary needs to be changed to recognise that even if no deliberate action has been taken, each MNE subsidiary contributes to the economic profit generated from the MNE and the extent of this contribution needs to be analysed as part of the existing 5 comparability factors.

6.4 Practical application of identical twin approach
The question as posed by the identical twin application of the arm’s length principle is: what price would an arm’s length party with all the attributes of the MNE subsidiary negotiate with an independent party?

In respect of intra-group financing, this question is easier to quantify as independent party methods are available to determine the credit rating of a MNE subsidiary and then to determine an appropriate interest rate. However, for other transactions such as the performance of research and development, manufacturing and distribution functions, operating as a MNE subsidiary as opposed to a stand-alone entity are virtually impossible to source. This is because the independent party/potential comparable will not bring the same characteristics to an independent party transaction as a MNE subsidiary, i.e. the independent party will not bring the benefit of being a related party with all the attendant decreased transaction costs, intangible asset protection etc. Therefore, how best is this transaction analysed?

6.4.1 Comparable Uncontrolled Price plus Allocation of Global Profit
In some instances there may be comparable uncontrolled prices available for specific transactions and these should be applied to price the actual transaction. However, if the

\textsuperscript{267} OECD (2010, 22 July) and OECD (2015a)
MNE economic rent is material, then adjustments will still need to be made to the comparable price to take into account the added benefit the MNE subsidiary contributes. This may mean that some element of profit split is required to allocate the MNE economic rent. Interestingly, this approach was suggested as being appropriate under the existing Article 9 wording in the OECD Model Tax Convention as early as 1986 by Langbein.268

6.4.2 Upper end of TNMM range

If there are no comparables available for the underlying transactions (as is most likely to be the case) within the confines of the arm’s length methods, there appears to be two other available approaches. These have both been foreshadowed in the guidance for further work on the profit split method which states:

“The December discussion draft269 raised questions about the use of profit splits to vary the range of results derived from a TNMM analysis by reference to increase or decrease in consolidated profits achieved by the parties to the transaction. The draft also raised a question about using a profit split to determine the expected share of profits, and then converting the analysis to a running royalty. Some commentators also felt that these were useful suggestions.”270

The first is a modified application of the TNMM. When benchmarking net operating margins, the comparable data has to be from entities operating independently and therefore not part of a MNE group. As outlined in Section 2 even within the existing approach, there will never be an exact comparable and the aim is to find as many broadly comparable entities as possible. The data set can range anywhere from 1 to 20 or more comparable entities.

The identical twin approach could still utilise the TNMM by searching for comparables that perform similar functions to the MNE subsidiary. However, when determining where in the comparable range the target net margin should be, in order to take into account the contribution to MNE economic rent made by the subsidiary, a net margin at the upper end, or upper quartile could be targeted or if there is low or negative MNE economic rent, i.e. losses either overall or at just the MNE economic rent level, a net operating margin at the lower end could be targeted. In the case of location savings, for example, this would mean that the contract manufacturer would earn a standard contract manufacturing return, but by

268 Langbein (1986), p.29
269 OECD (2014, 16 December)
270 OECD (2015a), page 59
targeting a net margin at the top of the range, this should allocate it some of the location savings that have accrued to the MNE group.\textsuperscript{271} If, however, the functional analysis showed that the location savings, or other contributions of the MNE contract manufacturing subsidiary were material and this method may not allocate enough MNE economic rent to the subsidiary, then the second approach, i.e. an application of the profit split method, may need to be adopted.

An important point should be made here though. In times when overall MNE group profit is low or even in losses, there needs to be some recognition that each MNE subsidiary may need to share in this loss. When lower profitability or channel losses occur, a full analysis will need to be undertaken to ascertain what has contributed to the losses and each MNE subsidiary’s attendant share.

6.4.3 Modified Profit Split Method

The final approach would be to apply the profit split method. The TNMM (or other methods if available) would be used to determine the routine return to the operating subsidiaries and then an analysis could be performed of the residual profit to determine how much the MNE subsidiaries should be allocated to reward them for their contribution to all aspects of economic rent.\textsuperscript{272}

The application of a ‘modified’ profit split method refers to a modification that may need to be made to the method in terms of its starting point, i.e. the residual overall profit to be split. Depending on the industry and drivers of economic rent (both general and MNE), a determination would need to be made whether the residual profit was calculated by reference to the geographic value chain (i.e. the overall global profit derived from sales made to customers in that geographic jurisdiction) or whether the global profit (i.e. the overall MNE group profit) was the starting point for the residual analysis.

An example of when the global profit may be the more appropriate starting point would be if the operations in one jurisdiction impacted the profitability of another jurisdiction. For example, where selling a product in the Australian market place, even though its profitability was low, resulted in the group’s reputation as a global company improving, leading to higher sales or profitability in other markets.

\textsuperscript{271} This approach is effectively suggested by Kane (2015)
\textsuperscript{272} This approach is suggested by Vann (2010)
Regardless of the starting point for the calculation of residual profit, when applying this method it would be imperative to fully understand the drivers of economic rent in the industry\textsuperscript{273} and the factors that influence the MNE economic rent for the particular group.

6.4.4 Pragmatic Approach

As noted by Vann\textsuperscript{274} “it is impossible to observe the line between risk and rents” and further “that the mix changes over time”. It is also therefore impossible to segregate the economic rent into the three categories of general economic rent, greater access to economic rent due to operating as a MNE and MNE economic rent. However, just because this allocation cannot be done with precision does not mean that each MNE subsidiary’s contribution to economic rent should be ignored.

By recognising the limitations of the existing comparability analysis and approach to the arm’s length principle, we are then in a better position to analyse the results and interpret the data. It is imperative that a facts and circumstances analysis of the taxpayer is continued with a full analysis of the MNEs global value chain and the industry in which it operates. As pointed out by Vann\textsuperscript{275} in one industry the institutions of the country of the purchaser can be relatively unimportant, for example the purchasing of a natural resource, whereas in another industry, for example, high technology or pharmaceuticals, as Vann notes “little or no value can be obtained from transactions with a country if it does not enforce the monopoly rights of the seller”.\textsuperscript{276} This dynamic is also illustrated by the analysis in Section 4. Therefore, it is imperative that the factors contributing to economic rent of the MNE group are fully understood.

It is only by doing such an analysis that a view can be formed as to what drives profitability in the taxpayer industry, how each MNE subsidiary contributes to that profit and what factors should be utilised to determine how profit should be allocated. One hopes that the table provided in Section 4.4 could at least provide a starting point for this analysis.

Commentators may criticise this approach on the basis that it has high compliance costs because there is such a divergence of economic generating factors amongst industries. However the author considers this is the best approach available. Globally a pragmatic

\textsuperscript{273} Porter’s 5 forces analysis is particularly helpful for this type of analysis, Porter (1980)
\textsuperscript{274} Vann (2014), p. 439
\textsuperscript{275} Vann (2003), page 146
\textsuperscript{276} Vann (2003), page 146
approach may be required to provide administrative safe harbours (possibly based on TNMM ranges for operational subsidiaries or alternatively a global formulary apportionment) for MNEs that fall below a certain revenue threshold. Further, as foreshadowed by Vann\(^{277}\), the compliance costs of the larger MNEs may be best managed by entering into Advance Pricing Arrangements ("APAs"). Given the increasing materiality of transactions across jurisdictions and the increasing need to take into account economic rent, multi-lateral APAs, rather than just uni or bi-lateral APAs, may be the best way to both minimise compliance costs and the risk of double taxation.

6.5 Does the identical twin approach address all the limitations of the arm’s length principle?

This section briefly revisits the limitations of the arm’s length principle set out in Section 3 and summarised in Table 4 and considers whether the identical twin approach addresses these limitations. The first limitation is recognition of intra-group contracts. As noted by Vann “the transfer-pricing thinking contains the basis for evolution from the transactional to a ‘whole of enterprise’ approach”\(^{278}\) and once you apply the TNMM approach as modified for the identical twin approach, or the profit split method, the need to reconstruct or disregard a particular transaction is mostly negated as the pricing methodology effectively ignores the individual transactions and focuses on an allocation of profit which takes into account the contribution of each entity to the value chain and the appropriate allocation of profit for this contribution. However, as also noted by Vann, it is important to guard against manipulation and therefore “freedom of contract and the permitted transactions [need to be]...constrained or certain types of transactions are simply presumed (to make up for incomplete contracts).”\(^{279}\)

As explained in Section 5, the 2015 Guidelines\(^{280}\) do go some way to allowing a tax administration to more effectively assess the substance of the transaction and also ignore the transaction in certain circumstances. Therefore, further amendments, other than a shift to an identical twin approach for all intra-group transactions, may not be required.

\(^{277}\) (Vann, 2003), p. 168
\(^{278}\) Vann (2003), pp. 135 and 168 and Vann (2010), p. 339
\(^{279}\) Vann (2010), p. 339
\(^{280}\) OECD (2015a)
The second limitation was the lack of comparability data. This limitation still exists however pragmatic solutions have been suggested to deal with this.

The third limitation is the undervaluing of intangible assets on transfer. This limitation is dealt with by the proposed changes to the recognition of intangible assets in Section 6.3.2. It is also an area that has been greatly improved by the 2015 OECD Guidelines\textsuperscript{281} in the work on goodwill and HTVI.

The final limitation on the failure of the arm’s length principle to deal with MNE economic rent was the impetus for the suggested interpretation and is sought to be addressed by the proposed identical twin approach and attendant amendments outlined above.

7. Conclusion

This working paper has reviewed the limitation of the existing arm’s length principle and the impact of the OECD BEPS project changes in the 2015 Guidelines on these limitations. The author considers that commendable progress has been made in a number of areas including the improved analysis of the substance of the actual delineated transaction, noting of the limitations of a one-sided approach when dealing with intangible assets, increased recognition of the impact of goodwill especially in respect of intangible asset transfers and a new approach to hard to value intangibles. However, this paper has identified that the continuing allowance of separation of functions, assets and risks, the lack of recognition of intangible assets that are not separately identifiable and the limited allocation of MNE economic rent to MNE group members still results in the allocation of the majority of MNE group profit to a centralised intangible asset owner, even under the 2015 Guidelines.

The author suggests that the best approach to resolve these problems is to extend the identical twin approach to the arm’s length principle, so as to encompass all types of transaction (and not just loan or interest rate pricing, where it has been largely confined to date). The broad application of the identical twin approach involves taking into account the full contribution a MNE subsidiary makes to MNE group profit. This will allow for an allocation of profit to the MNE group entities that contribute to value creation.

\textsuperscript{281} OECD (2015a)
Appendix I: Intangible assets: examples of valuation on transfer

The following examples are all in Annex to Chapter VI\textsuperscript{282} and relate to the transfer of intangible assets separate from the whole business, or an ongoing concern. They are relevant to section 5.4.2 of the paper which deals with the valuation on transfer of intangible assets between group entities.

The first relevant example is example 23\textsuperscript{283}. In this example a MNE acquires 100 percent of an unrelated entity for 100, representing 20 for tangible property and 80 for goodwill. The acquired entity then transfers all of its intangible asset rights to another entity in the MNE group and enters into a contract research and development arrangement with this entity. This other group entity has the financial capacity and capability to fund and direct the ongoing research and it will be the owner of both the transferred and any newly developed intangible assets. The commentary provides that the transferred intangibles must be specifically identified and valued. It depends on the facts how much of the 80 allocated to goodwill relates to the intangibles transferred to the intra-group entity and how much is retained by the entity which now provides contract R&D services. Importantly the commentary notes that generally “value does not disappear, nor is it destroyed, as part of an internal business restructuring”\textsuperscript{284}. The original owner of the intangible assets should be rewarded for its goodwill either in the transfer price of the intangible assets, or in the fee it receives for the ongoing contract research and development work.

The second relevant example is example 26\textsuperscript{285}. In this example a MNE acquires 100 percent of an unrelated party. The public trading value was 100, competitive bidders ranged from 120 to 130 and the company paid 160 on the basis of the complementary nature of the acquired entities existing and potential products. The accounting for the acquisition allocated 10 to tangible assets, 60 to intangibles and 90 to goodwill. After the acquisition the acquired company is liquidated and the purchasing entity grants an exclusive and perpetual license in respect of the acquired products for Europe and Asia to another group company.

\textsuperscript{282}OECD (2015a), p. 117
\textsuperscript{283}OECD (2015a), Annex to Chapter VI, paragraphs 83 to 85
\textsuperscript{284}OECD (2015a), Annex to Chapter VI, paragraph 85
\textsuperscript{285}OECD (2015a), Annex to Chapter VI, paragraphs 92 to 96
The example explains that the group company acquiring the rights for Europe and Asia should only pay a share of the acquisition premium to the extent the premium reflects the complementary nature of the acquired and existing products. For this purpose the accounting allocation is irrelevant. Therefore, if the premium can be linked to generating additional profit from the European and Asian markets then some of the premium should be included in the price of the rights when they are transferred intra-group. The issue is this approach requires a tax authority to prove a direct link with the premium paid and the generation of future income. As outlined in the paper, the direct pathways between intangible assets and income generation are rarely readily identifiable and this ambiguity allows for analysis which can undervalue the intangible assets transferred.

Example 27\textsuperscript{286} is the third relevant example. In this example, patents with a net present value of income streams of 80 are transferred, but the valuation of the entity transferring the patents is 100. The example notes the 20 difference appears too low, i.e. it appears that the transferred intangible assets have been over-valued. The commentary concludes further analysis would be required.

Finally in example 28\textsuperscript{287} a full risk manufacturing MNE group entity sells all its intangibles, including patents, trademarks, know-how and customer relationships, to another group entity. The acquiring entity has the personnel and resources to manage the acquired line of business and future development of intangibles. The acquiring entity then contracts with the original entity for it to perform contract manufacturing services. There are no independent party comparable transactions available and a valuation cannot reliably segregate particular cash flows associated with all of the specific intangibles. In these circumstances the guidelines provide it “may be appropriate to value the transferred intangibles in the aggregate rather than to attempt a valuation on an asset by asset basis”.\textsuperscript{288} This is especially the case if a valuation of the whole business was significantly higher than the sum of the individual valued intangible assets.

\textsuperscript{286} OECD (2015a), Annex to Chapter VI, paragraphs 97 to 100
\textsuperscript{287} OECD (2015a), Annex to Chapter VI, paragraphs 101 to 103
\textsuperscript{288} OECD (2015a), Annex to Chapter VI, paragraph 103
Appendix II: Global Formulary Apportionment

For many commentators including Avi-Yonah,289 Clausing290 and Durst291, the problems that exist with the arm’s length principle are insurmountable and they advocate for replacement of the principle with a global formulary apportionment approach. This approach allocates the consolidated global net profit of the MNE based on a formula made up by weighted allocation keys. The keys most often cited are sales, payroll and physical assets (i.e. intangible assets are excluded).

A variation of the global formulary apportionment solution was proposed by Li292. Due to criticism linked to global formulary apportionment the proposal was framed as a variation of the profit split method and called the Global Profit Split approach, but in reality it is more aligned to the global formulary approach. The Global Profit Split approach defines the taxing unit as the global integrated business (as opposed to the entire MNE business) and then allocates the global profit of this business based on a set of predetermined allocation keys. The suggested allocation keys include payroll, sales and both tangible and intangible assets. The method also includes various anti-avoidance measures, the main one being a factor throw-out rule which excludes tax haven entities from the allocation of profit. The main variations from global formulary apportionment are that a subset of global profit is used and intangible assets, as opposed to just tangible assets, are used in the allocation key. Both of these variations bring their own set of complications.

Some commentators have expressed the idea that a global formulary apportionment or some other form of allocation could be used as a back-stop. For example, Harvey293 suggests that where the application of the arm’s length principle generates a result which is materially different than an allocation using an agreed global formula then a compromise could be entered into between the taxpayer and the relevant taxation authorities for a result somewhere between the two allocations. An extension of this could be to monitor the effective tax borne by MNEs after their application of the arm’s length principle to their operations and where that rate drops below a certain level then a global formulary apportionment could be applied.

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290 Clausing and Avi-Yonah (2007)
291 Durst (2013)
292 Li (2002), p. 844
293 Harvey Jr. (2013)
The OECD has continually rejected the global formulary approach\(^{294}\) with the continued application of the arm’s length principle being confirmed as part of the BEPS agenda\(^{295}\).

\(^{294}\) OECD (2010, 22 July), paragraph 1.15
\(^{295}\) OECD (2015c), page 15
Appendix III: Modified Application of Arm’s Length Principle

As noted in Section 6, many authors have suggested various modifications to the arm’s length principle in order to overcome its perceived limitations. Some of these alternative approaches are outlined below.

1. Modifications to OECD Guidelines

Vann\textsuperscript{296} provides a detailed analysis of the limitations of the arm’s length principle and outlines some amendments that need to be made to overcome its limitations. His suggestions, in summary, are:

- **Recognition of contracts**: limitations need to be put in place so that intra-group freedom of contract is constrained;
- **For personnel**: salaries should be used as a measure to reflect their related contributions to the firm and no specific group of personnel should be privileged;
- **For assets and sales**: the primary allocation of profit for assets should be based on their place of use, with the place of creation of assets, if different, being given usually a lesser reward. This means for intangibles, the place where they generate sales\textsuperscript{297} will get the higher reward. So, for example, if a marketing intangible generates sales in a market, the majority of profit will be allocated there; and
- **Risk**: should not generally be treated as separable from the place of use of assets, especially firm-specific assets that are often regarded as one of the hallmarks of firms.

Ultimately, Vann suggests the above amendments will require recourse to the profit split method in order to adequately allocate the residual after partial allocation of profits has been done by way of pricing the intercompany transactions. He is careful to point out that this approach is not the same as a global formulary apportionment based on personnel costs, assets and sales and he notes the main difference is that “the profit split...tries to reflect the actual position of the firm.”\textsuperscript{298} Finally, he also notes “The outcome [of his suggested changes] in one sense is not far removed from the current transfer pricing rules, as it generally follows the contours of the rules by using transactions and focuses on similar

\textsuperscript{296} Vann (2010)
\textsuperscript{297} As pointed out by Vann (2010) the artificial avoidance of Permanent Establishment (“PE”) status can mean sales are not allocated to the jurisdiction in which they are made. As this problem has not been a focus of this paper, possible solutions for remedying this issue are not considered in this section.
\textsuperscript{298} Vann (2010), p. 339
issues. What is different and important are the constraints or presumptions that are introduced into the transactional framework. To some they may seem relatively minor changes, but for the transfer pricing specialist they will be recognised as major, even though articulated in a similar framework.\(^{299}\)

2. Comparability adjustments

Kane\(^{300}\) performs a thorough analysis of what he calls a notional synergy asset. He breaks the analysis into three components:

- **unilateral integration value**: the combination of two intangible assets which, when combined within a single corporate entity have more value;
- **bi-lateral integration value**: the value that corporations generate by integrating their assets with an arm’s length party’s assets via contract where together the assets have more value; and
- **common control value**: the value from controlling two assets under common control.

He notes that uni and bi-lateral integration value can be accessed by independent parties either by combining assets within a single independent party (uni-lateral value) or contracting between two independent parties (bi-lateral). As such, he recommends that if value is created by these types of integration by way of related party transactions, comparable data should be able to be sourced to determine what an arm’s length allocation of that value would be. His recommendation for common control value is for it to be allocated at the discretion of the taxpayer, on the grounds that prescribing an allocation of this profit would overstep the arm’s length principle as this principle is meant only to limit the price of a transaction to an arm’s length price, and not to allocate extra profit that is generated from the group as a whole.

Kane himself admits that the measurement of the different components of integration value is difficult, but suggests that these difficulties, along with the difficulties with sourcing comparable data could be overcome through “greater coordination of how to deal with arm’s length ranges.”\(^{301}\)

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\(^{299}\) Vann (2010), p. 340  
\(^{300}\) Kane (2014)  
\(^{301}\) Kane (2014), p. 311
His conclusion is that a novel synergy intangible should not be recognised by the OECD Guidelines on the basis it cannot be readily defined or measured. Due to this lack of precise measurement it is of danger of including elements of profit that can be realised by independent parties (i.e. the uni and bi lateral integration value) and therefore dealt with by comparability adjustments. Including it as an asset “will increase the spectre of overlapping claims of tax base as there will be no ready consensus as to its extent.”

His recommendation is that the focus in transfer pricing should remain “on legal ownership of recognised asset categories, which assets themselves are separately transferable.”

There are two overarching issues with Kane’s suggestions. First, lack of comparability data means that measuring uni and bi lateral integration with any precision is unlikely and therefore measuring appropriate adjustments is also unrealistic. Second, leaving allocation of the common control value to MNE’s may result in an under or over-valuation of the contribution of each MNE subsidiary, most likely dependent on the relative tax rates of the affected tax jurisdictions, a result which is no different to what occurs now.

3. Modified Profit Split Method

Avi-Yonah suggests a modified application of the profit split method where the traditional transactional and/or TNMM are used to allocate the routine returns and then a formula based on sales, fixed assets and payroll is used to split the residual global profit.

Kadet also suggests a simplified application of the profit split method to overcome the fact intensive nature of the existing method required to determine the appropriate profit allocation keys and the difficulties tax authorities have in auditing the appropriateness of the allocation. Under the proposed simplified approach, ostensibly all MNEs would have to use the method unless they can illustrate another method is clearly superior. The method would be applied using weighted “concrete objective allocation keys” which had been agreed and developed for all common business models. Guidelines would also be issued articulating the principles that guided the determination of the allocation keys for the various

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302 Kane (2014), p.311, noting this is very similar to the conclusion of the 2010 Guidelines in paragraph 1.10 where it is stated there is “no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises”.
303 Kane (2014), p. 311
304 Avi-Yonah (2010)
305 Kadet (2015)
306 Kadet (2015), page 1185
business models so that if new business models emerged, objective allocation keys would be easily determined.

The benefits of this solution are the allocation keys will be known by all, they are tailored for each industry and business model and there should be consistency of approach. It also saves a detailed fact audit by the tax authorities.

The problem with this approach is that by using allocation keys, it has all the problems associated with a global formulary apportionment including obtaining global agreement on the allocation formula. In fact it increases these problems as formulas would have to be agreed for each business model and industry. In addition, because it is using a sub-set of global profit, being the relevant global chain profit, it still contains the limitations of the profit split method in respect of determining which entities should be in the value chain, the calculation of channel profit and the possible exclusion of some portion of MNE economic rent from the value chain profit.
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