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Anti-Abuse Notion of "Control over Intangible-Related Functions" Is Beyond the Arm's Length Principle

This article takes the position that Example 17 (on intangibles) of the OECD Transfer Pricing Guidelines (2017), which focuses on the issue of control over a research activity and the relationship between control and entitlement to ownership of an intangible and the revenues it generates, is not grounded in theory or in empirical evidence under the arm's length principle.

1. Introduction

Example 17 (on intangibles) of the OECD Transfer Pricing Guidelines (OECD TPG)[1] discusses the scenario of a purchaser of a research project wanting to acquire intangible property that may potentially be created through the research process. The OECD TPG 2017 recharacterize the purchase as a loan to the researcher if the purchaser lacks the ability to control the researcher's activity. The OECD TPG affirm that, in such a scenario, a loan, and not a purchase, is commercially rational and in compliance with the conditions independent parties would agree upon, i.e. the arm's length principle (ALP).

Based on the economics of contracts and key empirical studies on credit rationing, the author argues that both a purchase of the research, as well as a loan, are compliant with the ALP, provided that the necessary adjustments (which are more relevant to the loan) are made.

The conditions that underlie Example 17, which include a high degree of risk associated with the project at an early stage, the competitive position of the investor in the market, as well as competition between lenders or research providers, all play a role. It is theoretically irrelevant which type of contract (loan or purchase) is concluded: the actual residual claimant of intangible returns, the remuneration of which is significantly variable given the assumed risk of a positive or negative result, is always the funder of the investment, regardless of whether he is the lender or the purchaser of the research.

This holds true if the loan interest is correctly calculated at a rate adjusted for the high risk, based on the facts of Example 17. In a capitalist economy, the loan would not likely be granted[2] because of credit rationing, assuming the borrower (the researcher) has no assets that can be put up as collateral.[3]

Example 17 does not explicitly mention securitization of the loan or the borrower's creditworthiness, which the author takes into account as a necessary adjustment. If the borrower provides collateral, the loan can be granted, and the same borrower would truly become the residual claimant of the gains or losses of the project. This is not, however, due to his control over the research activity, but rather the fact that he put his capital at risk. In any event, the fact that security can be provided for the loan does not substantiate the recharacterization of the contract; it only makes the loan an allowable option.

The author contends that recharacterization of contracts under the OECD TPG on the basis of a lack of control over intangible-related functions is not grounded in theory or based on empirical evidence under the ALP, despite the OECD's assertion.

The author accepts that the company funding the investment must have enough structure to avoid being challenged as a mere "cash box". In this article, it is assumed that the research funder falls above that minimum threshold. Proof of the author's proposition, its main consequences and a proposal to avoid abuses in respect of transfer pricing transactions are discussed in sections 2. to 6. Section 2. discusses the difference between the acquisition of research and a loan. Section 3. outlines the mechanics of an ALP assessment and the problem of valuing intan-

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1. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), International Organizations' Documentation IBFD [hereinafter OECD TPG], Example 17, annexed to Chapter VI. The Example deals with the purchase, at an early stage, and the subsequent development of a research project. The author focuses on the subsequent development of the research project and not on the previous purchase and the related price.

2. *See* J. Stiglitz & A. Weiss, *Credit rationing in Markets with Imperfect Information*, 71 The American Economic Rev. 3, p. 393 et seq. (1981).
3. *See* R. Mookherjee, *Contractual Structure and Wealth Accumulation*, 92 American Ec. Rev. 4, p. 819 (2002); J. Stiglitz, *New Theoretical Perspectives on the Distribution of Income and Wealth among Individuals*, paper presented originally at the IEA/World Bank Roundtable on Shared Prosperity, Jordan, 10-11 June 2014 and at an INET seminar at Columbia University, 3 Dec. 2014; and M. De Nardi & G. Fella, *Saving and Wealth Inequality*, 26 Review of Economic Dynamics 295 (2017).

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gibles. Section 4. addresses the commercial rationale of a research acquisition versus a loan in capitalist economies in a real bargaining context. Section 5. looks at recharacterization of contracts. Section 6. presents the author's conclusions.

2. Research Acquisition Versus Loan: A Comparison of Economics

2.1. A high-risk research project at an early stage developed in a competitive market

Assume the existence of a group comprising companies S and A, which is managed as one firm through the integration of their economic activities. The group activity is aimed at developing a research project regarding the possible "discovery" of a new intangible that would grant the group a competitive advantage over other firms in a target market; the activity can be segmented into two (main) economic functions: performing the research activity and funding it.

Funding is carried out through ownership of relevant liquid equity capital and by managers (or a board of directors)[4] who are fully able to decide how much to invest, where to do so, on what terms, and for how long. The research activity is performed by a staff of researchers and their managers.

2.2. Compliance with the OECD TPG in relation to the acquisition of research when the buyer controls the development activity

Considering the facts of Example 17 of the OECD TPG (annexed to Chapter VI on Intangibles), the author makes the following assumptions:

– S is the funder of a research project, and is also its "leader", hiring key managers charged with conducting and controlling the activity;
– A is the developer of the research activity, not in terms of investing capital, but in terms of hiring the staff of researchers who work under the instruction of research managers; and
– S purchases the research service performed by A, by reason of which S acquires the potential intangible property resulting from the research; A's remuneration covers the costs of the research, plus a profit extracted from (market) comparables.[5]

Under the rules of the OECD TPG, this contract is commercially rational and in compliance with the arm's length principle, mirroring conditions that independent parties would have agreed upon.

2.3. The funder's lack of control over research activity and recharacterization of the acquisition as a loan

Assume that there is a change in the functions performed by S and A. S only funds the activity, while A performs the whole research activity and hires the staff of researchers and related key managers.

Actions 8-10 of the OECD's BEPS Action Plan[6] assert that in this scenario:

> An associated enterprise providing funding and assuming the related financial risks, but not performing any functions relating to the intangible, could generally only expect a risk-adjusted return on its funding.

Example 17 states that the funder of the intangible is not allowed to purchase an intangible property (giving it entitlement to the associated revenue) when it lacks the ability to control the development as performed by other group companies. The purchase contract is recharacterized as a loan, granted to A, in an amount equal to the purchase cost of the property and of the ongoing research activity undertaken to further develop the intangible.[7] This article now turns to an examination of the economics of both forms of contract, i.e. acquisition of the research and a loan, with the help of a simple numerical example.

4. They are the directors or managers who are charged with leading the investment based on the powers listed in the text. It is assumed that the managers or directors have sufficient powers to avoid the company being challenged as a mere "cash box". In this example, the focus is not on the "cash box" problem; it is assumed that the company that funds the project has enough substance so that it is not considered a "pure cash box". *See also infra* n. 35. With regard to the economic substance of the funder of the research project, the author shares the opinion of P. Barnes et al. in OECD, *Public Comments Received on Discussion Draft on Actions 8, 9 and 10: Revisions to Chapter I of the Transfer Pricing Guidelines (Including risk, recharacterisation and special measures) of the BEPS Action Plan* (2015), available at http://www.oecd.org/ctp/transfer-pricing/public-comments-actions-8-9-10-chapter-1-TP-Guidelines-risk-recharacterisation-special-measures-part2.pdf, who affirm (at p. 634 et seq.) the following:
   > As we have discussed, in extreme circumstances it may be appropriate for tax authorities to non-recognize a pure "cash box" structure, i.e., where the entity does not have or exercise the capability to oversee risks managed by another, but in transactions characterized by good corporate governance practices, where the low-functioning entity has the capability to manage investment risk, normal transfer pricing approaches should be sufficient to address mis-pricing through, for example, overcompensation of the investor and under-compensation of the project manager". And further, "[a] typical investor in the marketplace controls and manages investment risk by deciding how much to invest, in what, on what terms, and for how long. Many investors don't have meaningful control beyond these matters yet no one questions their right to the full residual return.
5. Example 17 affirms that the reason why S cannot become the intangible owner is simply S's lack of control over the research activity. Conversely, if S has control over the research activity, i.e. it hires key research managers, it would be allowed to become the intangible owner, regardless of whether or not the development of the research project is assigned to A's staff of researchers (under instruction of managers of S). Profit based on comparables refers to the profit of independent firms that are comparable to the tested group company, under the comparability standards established by the OECD TPG.
6. OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Report* p. 65 (OECD 2015), International Organizations' Documentation IBFD (hereinafter *Actions 8-10 Final Report*).
7. Extract from Example 17 annexed to Chapter VI of the OECD TPG (2017):
   > Because Company S lacks the capability to control research related risks, Company A should be treated as bearing a substantial portion of the relevant risk and Company A should also be compensated for its functions, including the important functions described in paragraph 6.56. Company A should be entitled to larger returns than the Contract Research Organisations under these circumstances. [...] A thorough examination of the transaction in this example may show that it should accurately be delineated as the provision of financing by Company S equating to the costs of the acquired intangibles and the ongoing development. As a result, Company S is entitled to only a financing return. Company A would be entitled to retain the remaining income or losses.

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2.4. Acquisition versus loan: A comparison in the context of Example 17

The following simple numerical example illustrates the case described in section 2.3., i.e. a situation in which S only funds the activity while A performs the research activity (with researchers and their managers).

Assume that a research project is in its early stages such that it can be assumed to have an expected value[8] (ex ante) of (nearly) zero given a competitive environment that includes other firms making similar investments and the potential entry of new firms. Imagine also a significant risk associated with the project. The significant variability (ex post) of the possible results can be expressed using the research outcomes (+1,000, 1-1,000).

S invests 1,000 of his equity capital in the research activity, which will be performed by A, who has no capital but hires the managers and researchers developing the project and whose salaries are equal to 1,000 for the whole project.[9]

2.4.1. The research purchase contract

S purchases (at market value) the research activity performed by A and will potentially acquire ownership of the intangibles developed. A only has to pay the researchers and their managers. It is assumed that competition between those who perform research pushes the profit of A towards zero, with no risk (no variability of possible results)[10] involved.

S will be the residual claimant of the gains or losses of the project after paying A for its services. S has a largely variable remuneration because the project may lead to a valuable intangible, which ex post will count as a gain of 1,000.1 with a 50% probability, or a failure, which ex post will be accounted for as a loss of the invested amount of 1,000, with the same 50% probability.

2.4.2. The loan contract

2.4.2.1. The non-secured loan

Now, assume S extends a loan of 1,000 to A, at a rate that is adjusted for risk. This is exactly what is stated in Example 17, which provides for the recharacterization of the acquisition of the intangible as a loan when S lacks the ability to monitor the development.

A is the (formal) residual claimant of the project revenues, i.e. the amount remaining after paying back interest and capital to S. If A is not able to pay back the loan, he must declare bankruptcy and S will acquire ownership of the project.[11] In the credit market, there is also competition between potential lenders, pushing the profit of S towards zero.

The rate adjusted for risk can be calculated keeping in mind that if the research project is a failure, A will declare bankruptcy and not pay S back, the probability being 50%. In this scenario, S will lose his credit of 1,000. To earn an ex ante expected profit of zero (competitive profit), S must set the interest rate so as to recover double the amount lent (100% interest rate) if the result is positive and A is able to pay back the loan.[12]

A is the formal residual claimant of project revenues only because he receives, ex post, fixed remuneration with no risk (no variability), which is a profit of nearly zero (probability of 100%). S, the lender, with a fixed rate of interest (100%), has, instead, significantly variable remuneration and so is the actual residual claimant of the project revenues. He will gain ex post 1,000 (100% interest rate) if the results are positive (50% probability) but will lose 1,000 if a negative result occurs (50% probability) (i.e. A's bankruptcy).[13]

2.4.2.2. Competitive interest of 100% (for a high-risk research investment at an early stage)

An interest rate of 100% is not the norm in actual credit markets; in this scenario, it is simply the rate calculated by adjusting for the given risk conditions and an ex ante competitive expected profit of 0 for the lender. What "appears ex post to be pure rent (1000), in fact has been produced through an investment (the loan) that ex ante was gained only via a competitive return (expected profit = 0)".[14]

2.4.2.3. The secured loan: An extension of Example 17

If S is not inclined to assume high risks, it may decide to grant the loan to A on condition that A pledge its assets as security (collateral). If A fails to make his repayments, S can foreclose on the collateral, selling it to recover the credit. Example 17 does not explicitly mention loan securitization or a borrower's creditworthiness. As such, the following analysis represents a natural extension of Example 17.[15]

8. The expected value is the probability-weighted average of all possible results.
9. First, it is assumed that firms are able to make realizable projections of future results and of their probability and that the tax administration has complete information in this respect. Next, the actual information gap of tax administrations on future data projections is addressed. Finally, an analysis is provided of the asymmetric information between independent parties.
10. The existence of a competitive environment for the research project at an early stage with a high degree of risk implies that the expected value (profit) of the project = 0 and that there is a large variance of possible results with regard to the mean; a competitive market for the researchers with no risks implies that, for these providers, the expected profit = 0, with no variance of possible results with respect to the mean.
11. In this example, A has no other assets (the example mirrors the facts of Example 17).
12. The amount was calculated to be 100% of the interest rate (competitive interest rate with an expected value of 0) but under actual banking models the rate can be higher. Actual models consider the "Basel capital requirements" and, as such, calculate a (competitive) interest rate of nearly 107% when the projected loss is 100% of capital subject to a probability of 50%; note that it is not assumed that any risk aversion of the lender would cause a further increase in the interest rate.
13. After a declaration of bankruptcy, it is assumed that the borrower will no longer be the owner of the project result (and of other assets if they exist) because ownership of the project is transferred to the lender. At the end of the proceedings, the borrower's (A's) debt is discharged.
14. J. Hines Jr., *The Transfer Pricing Problem: Where the Profits Are*, NBER Working Paper No. w3538, p. 3 (Dec. 1990), available at https://ssrn.com/abstract=226838.
15. High interest rates and "credit rationing" are dealt with in sec. 4.2., which is the effect of not having actual lenders willing to grant loans by increasing interest rates. Example 17 does not mention the loan securitization or assets that A may use as collateral; it only makes refer-

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Going back to the loan by S to A for 1,000, assume that A provides collateral for the entire sum borrowed. The credit market is still competitive, so the profit of S is again moving towards zero. The parties' pay-off is as follows: if the result is positive (50% probability), A has a gain of 1,000.1 (after repaying the loan to S); if the result is negative (50% probability), A loses collateral worth 1,000. S will have no profit, but no loss, with a 100% probability (no risks) because, if the result is positive (50%), A will pay back the loan, while, if the result is negative (50%), S will recover his credit by selling the collateral.

A is now (formally and actually) the residual claimant of the project revenues, with the remuneration being significantly variable. As such, A has truly assumed the developmental risk.

2.5. Parties' indifference in opting for a loan or a purchase: Under either scenario the residual claimant is the funder

On the basis of the assumptions outlined in section 2.4.1. and 2.4.2. concerning (1) competition in the target market of the investment, (2) the high-risk aspect and early stage of the project and (3) competition among segmented function providers (lenders and researchers), the (formal) role of the residual claimant, and whether a loan or an acquisition is opted for is not relevant in terms of establishing the parties' remuneration.

Given an ex post gain of 1,000.1 or a loss of 1,000 (with 50-50 odds), the result is, in any event (almost completely) attributable to S, who is the actual residual claimant of the project's results, regardless of whether he is a lender or purchaser.

The outcome is different only if A provides collateral to secure the loan. In this instance, A becomes the residual claimant of the gains or losses of the project, but not due to his control over the research activity, but rather because he put his capital at risk.

Section 4.1. will introduce new assumptions to deal with the full complexity of strategic interactions among privately informed parties in a true bargaining context, which will allow for more "sophisticated" conclusions.

2.6. The role of the residual claimant (intangible owner) of integrated business results

If any of the three assumptions implied in Example 17 are changed, the (formal) role of the residual claimant (regardless of which contract is at issue) becomes relevant. At the moment of the transaction, if it is already known that the investment project will have a positive outcome, playing the role of residual claimant[16] is relevant. The residual claimant's role is based on a case-by-case assessment (one size does not fit all), which is dependent on factors that are true drivers of ALP compliance (*see* section 3.1.).

For instance, if the investment is projected to yield significant results with low risks and, in reference to Example 17, A has a monopoly on developing the project as a result of past investment and assumed risks, the recharacterization of the research purchase as a loan by S to A could be a possible option. This is appropriate in order to avoid a value shift (in breach of the ALP) from A to S. Another option could be for S, before paying for the ongoing research, to also pay for the highly valuable intangible already developed by A.[17]

ence to a "thorough examination of the transaction". Example 17, in the annex to Chapter VI of the OECD TPG (2017), states that: "A thorough examination of the transaction in this example may show that it should accurately be delineated as the provision of financing by Company S equating to the costs of the acquired intangibles and the ongoing development. As a result, Company S is entitled to only a financing return".

16. The role of the residual claimant is relevant, for instance, when unforeseeable events occur after the contract is signed because whoever plays that role under the contract's provisions is entitled to actual profits (or losses). Comparing the actual and projected results according to the use of intangibles is known, in the tax literature, as periodic adjustment of the price of the intangible property and is one of the most problematic issues. Many (including the OECD) have long debated the rule (and IRS regulations) introduced in 1986 as sec. 486 of the US Internal Revenue Code (IRC), which provides that: "In the case of any transfer (or license) of intangible property ... the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible". If actual events were predictable based on information available at the time the contract is signed but were not accounted for in the calculation of the expected value, the price set under those projections would not be appropriate and a periodic adjustment of that price would be appropriate. However, if actual events were not foreseeable, the price adjustment would not be appropriate; in the 1990s, sec. 482 of the IRC provided for this rule, but in more detail and subject to certain exceptions to the price adjustment, in circumstances in which there was a significant difference between projected and actual results. In general, the periodic adjustment issue highlights the need to true-up projections on the basis of actual data. A further problem relates to the nature and the limit of the true-up because prices are set by independent parties, based on information available at the time of the contract signing, which does not include facts arising several years later (i.e without the benefit of "hindsight"). *See* para 3.73 OECD TPG (2017), which states, regarding hindsight, "In other circumstances, where there is no reason to consider that the valuation was sufficiently uncertain at the outset that the parties would have required a price adjustment clause or would have renegotiated the terms of the agreement, there is no reason for tax administrations to make such an adjustment as it would represent an inappropriate use of hindsight". A reasonable tax law should provide for clear rules on all of these valuation problems. There is a vast amount of literature on the issue of periodic adjustment of intangible prices, including, amongst others, J.R. Mogle, *Intercompany Transfer Pricing for Intangible Property*, 6 BNA TM Special Transfer Pricing Report 2, Report Number 25, p. 6 (1997); B.C. Becker, *Projected and Actual Profits' Impact on Licensees*, 17 BNA TM Transfer Pricing Report 461 (10 Sept. 2008); OECD, *Intercompany Transfer Pricing Regulations Under US section 482: Temporary and Proposed Regulations*, Report of Fiscal Affairs Committee (OECD 1993); A.J. Barbera, *Considering Risk in Trademark Royalty Arrangements*, 12 BNA TM Transfer Pricing Report (28 May 2003). More recently, *see* Y. Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 Va. Tax Rev. 79 (2008); J. Wittendorff, *Valuation of Intangibles under Income-Based Methods – Part I*, 17 Intl. Transfer Pricing J. 5 (2010), Journals IBFD; regarding limits on the adjustment of intangible prices under the US legal framework, *see*, for example, K. Brewer, *IRS Commensurate With Income Powers: Exploring Their Limits*, Tax Notes 1281 (7 Dec. 2015).

17. *See also* Schön, who notes that a high (ex post) profit may stem from two different situations, i.e. from a monopolistic or from a risky competitive situation (W. Schön, *International Taxation of Risk*, Max Planck Institute for Tax Law and Public Finance, Working Paper 2014-03 (2014) and W. Schön, *International Taxation of Risk*, 68 Bull. Intl. Taxn. 6/7 (2014), Journals IBFD. He affirms: "It is hard to distinguish in practice between an inframarginal profit which stems from the exploitation of a monopolistic asset (i.e. an economic rent) and a profit which simply represents the volatile outcome of risk (like a lottery gain) [...] Behind each transferred 'risk' there can always exist some transferred 'hidden intangible' whose existence disproves the presumption that risk shifting works in a symmetric fashion".

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The residual claimant's role is fundamental in a transfer pricing analysis governed by the ALP. This issue will be addressed in section 3.1.

3. ALP Assessment and the Problem of Intangible Valuations

3.1. ALP assessment versus formula division of business results; governments at a disadvantage in terms of business information regarding firms

Methods other than the ALP are based on simple accounting factors (such as sales, salaries, fixed assets) used to allocate the profits of multinationals. Such factors yield predictable outcomes.

Formulas themselves do not, however, reflect market forces. They do not duplicate conditions independent parties would have agreed upon, nor do they have the positive features associated with the ALP.[18] Furthermore, it is nearly impossible for all countries concerned to reach agreement on formulas.

The ALP aims to allocate the results of a multinational business carried on by different units when each economic unit is located in a different state and each manufactures intermediate inputs for one another. The ALP assigns:

- anything more than a market return (based on comparables) to the capital of affiliates that do not participate in the risks (i.e. variability of results) of the whole business activity; and
- any residual profit or loss (that remains from the global result of the group after having assigned market returns as above) to the capital of affiliates assuming the entire risk of the activity.[19]

Before changes arising from the BEPS Project, the OECD TPG, subject to a proper interpretation, were based on the economic model that has been described herein.[20] Anyone who wants to establish and audit ALP compliance must undertake a case-by-case assessment of the capital risks assumed by the affiliates, applying the rule described herein. Firms set this in advance and administrations perform the auditing at a later stage.

Affiliates entitled to the residual results of the group, who assume the related risks, or have assumed them in the past, must be established as such in intra-group contracts. Any shortcut used to apply the ALP is deemed inappropriate.

A problem arising in applying the ALP is that group directors, in planning their investments, know (or should know) the risk conditions and the projected results of their business, while governments do not.

Tax authorities, in conducting tax audits to verify compliance with the law, are worse off with regards to information about the degree of business risk than group managers. First and foremost, tax officers can only observe the actual results of the business during audits, which are often arranged years after the transactions have taken place and might not understand the distribution (of the randomly determined variable) of possible (projected ex ante) results from which that actual result stems. As such, they must rely on a mix of information collected by firms and from other sources.[21]

In conclusion, with regard to information, tax administrations are at a disadvantage relative to firms when it comes to the main driver (risk conditions) in establishing and auditing ALP compliance.

3.2. Valuation of intangible assets based on data projections

In a substantial number of cases, however, an objective assessment of the ALP is possible because a sole group affiliate is entitled to intangible revenues, having assumed the past (and future) risks of the integrated business. The ALP is applied here with a certain degree of objectivity because transfer prices are set by fixing the remuneration of affiliates, not owning intangibles, by reference to market comparables.

Conversely, a critical aspect to consider is the valuation of intangible assets based on profit (or loss) projections regarding future intangible use. This happens during a transfer of intangibles, intangibles developed in sequence[22] by different group companies, as well as in

18. The positive features of the ALP include neutrality in terms of the allocation of resources (independent and group companies are put on the same putting), efficiency (i.e. there is no incentive for group companies to incur higher expenses than independent companies) and equitable division of tax revenue between countries.
19. *See* Hines *supra* n. 14 and A. Musselli, *Arm's Length Intragroup Intangible Transfers: Economics, Regulations and Actual Behaviors*, ECONPUBBLICA Working Paper No. 108 (2006), available at http://dx.doi.org/10.2139/ssrn.878443.
20. Additionally, the US Regulations regarding section 482 of the IRC, subject to certain peculiarities, are based on the same economic principle (they are the "mother" of the OECD TPG). The UK tax authorities (HMRC) make reference to similar concepts to those of the text, observing that it is necessary to investigate the implied model in the OECD TPG. *See HMRC Manual on Transfer Pricing and Bargaining Power*, available at https://www.gov.uk/hmrc-internal-manuals/international-manual/intm485050.
21. *See*, for example, A. Musselli & A. Musselli, *Saving Arm's Length Pricing: From Economists' Myths of Tax Avoidance by Taxpayers, to the Reality of Uncertain Application of Rules*, 19 Intl. Transfer Pricing J. 6, p. 391 et seq. (2012), Journals IBFD. Hines (*supra* n. 14, at p. 25) is confident regarding the possibility of enforcing a system where tax administrations can also rely on business information in applying the ALP. He noted that firms are also not always aware of their own costs and demands. One group of authors observed that: "asymmetry of information between Taxpayers and Administrations to evaluate some operations, ... probably ... goes back to the first income tax laws that were put in place during the Middle Ages" (D.R. Wright et al., *The BEPS Action 8 Final Report: Comments from Economists*, 23 Intl. Transfer Pricing J. 2, p. 7 (2016), Journals IBFD).
22. Where more than one affiliate is involved in bearing the risks of the whole group activity, it is necessary to estimate the relative contribution of each party to the overall value produced by intangibles (residual profit after having assigned a market return for comparable functions). A simple way to do this would be to divide residual results in proportion to the capital investments of affiliates bearing those risks. This is not, however, appropriate when capital investments were used to finance expenses incurred in different periods and the information about the results of a global integrated business is different at the time each party made its own investment (intangibles developed sequentially rather than simultaneously). Take the "old" problem of marketing expenses. Briefly, the manufacturer may become, before any marketing is done and financed, the owner of a bottleneck input (like a registered

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respect of buy-in payments to value previous contributions under a cost sharing agreement. In such scenarios, governments (of high-tax countries) are at a maximum disadvantage relative to firms that are able to avoid disclosing the "right" information about data projections with the aim of lowering taxes.[23]

The valuation of intangibles is an old and well-known problem, especially to economists. Major historical controversies, cases of abuse or of purported abuse that came to light, were often related to the valuation of intangible transfers. Legislators might focus on these transactions from the perspective of ensuring that the relevant procedure produces predictable results regarding values, which may lead to a conflict of interest between administrations. The possible conflict must be solved by arbitration.

Uncertainty regarding valuation techniques can even exist in the field of economic theory, in particular regarding the value of firms or of individual intangible assets (such as trademarks, patents, etc.),[24] but might not exist in the field of tax regulation, in respect of which predictable rules on taxpayer behaviour are necessary. It should no longer be acceptable for firms and tax authorities to quote the OECD TPG in order to justify "everything and its opposite", as regards arm's length pricing and the value of intangibles.

In order to provide more certainty in respect of tax regulations, a first step might simply involve the text of the OECD TPG, which remains steeped in vague and diverse economic theories that give very little practical guidance. Objective parameters to be implemented for intangible transfers include, for example, which valuation method (or methods) to be used, the choice of whether or not to use ex post valuations or rely on true-up profit projections (with related exceptions to avoid the need for hindsight), and which documents firms must disclose to limit the informational advantage they have over tax administrations.[25]

Once the rule is established – and in this respect the law allows for more than one option because a variety of methods are deemed to be consistent with the ALP - tax regulations must (at least) confirm that all methods are allowed.[26] A second fundamental step needed to give certainty to tax rules concerning the valuation of intangibles based on data projections should be to adopt a procedure to settle a potential conflict of interest among the parties. When independent parties set a price based on profit projections, such as for intangible property, a conflict of interest can arise.[27]

The question that remains is who the interested parties are and how a conflict of interest can be discerned if there is a single group of companies. The issue of price setting has to be resolved by the minority shareholders, aided by a referee, for the following reasons.

In setting market prices, there is always an independent seller and an independent buyer, and consequently a conflict of interest. Similarly, international treaties might provide for mandatory rulings between conflicting tax administrations, such that the buyer and the seller would be represented by the tax administration that has taxing power over them. Tax administrations are akin to minority shareholders[28] of buyers and sellers and truly have conflicting interests because what increases the tax base of one decreases the tax base of the other. An independent arbitrator (the referee) has to set the price where there is disagreement between the parties at issue (tax administrations and enterprises). Arbitration might be agreed upon in treaties, at least in respect of litigation between tax administrations, in the context of an income adjustment in respect of an affiliate. This is the only way to avoid never-ending discussions[29] in cases that are somewhat subjective given that what is at issue is the valuation of an intangible.

patent). An example is the famous American *Glaxo* case and the harsh litigation between the company and the US IRS. *See* A. Musselli & D. Marchetti Hunter, Glaxo *Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues*, 14 Intl. Transfer Pricing J. 3, p. 165 (2007), Journals IBFD and D. Wright, *Glaxo to pay USD 3.4 billion to settle largest tax dispute in IRS history*, BNA TM Transfer Pricing Report (13 Sept. 2006-22 Nov. 2006).

23. *See*, for instance, what McDonald, a US Treasury economist, declared at an OECD public discussion in 2012: "Isn't this a fundamental problem, the notion of information asymmetry? Tax administration may find it difficult to establish what profits were reasonably foreseeable at the time the transaction was entered into". In the same 2012 Paris public discussion, Musselli asked tax administrations to reject the use of hindsight: "The first actor that is going to set prices is the firm. So it is not acceptable that firms are going to choose to set in advance prices and then the Administrations, only based on comparables, are going to apply a true-up only after the tax return". An overview of the 2012 OECD public discussion is provided in R. Mitchell, *Andrus cites 'Inconsistent' business stances on weight of legal agreements, comparables*, One Source Transfer Pricing (13 Dec. 2013).
24. Those familiar with the valuation of businesses and intangibles (and not only transfer pricing) know well that one can use different techniques. With regard to businesses, the focus is on future cash flows, capital value and market comparables and, with regard to intangibles, market, cost or income values; *see* R.A. Brealey, S.C. Myers & F. Allen, *Principles of Corporate Finance* 617 (McGraw-Hill 2007). For a European perspective, *see* M. Bini & L. Guatri, *La valutazione delle aziende* (Egea 2007).
25. In line with this position, *see* N. Zuurbier, *Transfer Pricing in a Post-BEPS World – Transfer Pricing Aspects of Intangibles*, ARN 621793 (6 June 2016), Master thesis Eucotax Wintercourse, Tilburg University, available at http://arno.uvt.nl/show.cgi?fid=141892. *See also supra* n. 16 and related authors who suggest objective parameters that may support intangible valuations. *See also* Wright et al., *supra* n. 21. The OECD prepared a draft document on the valuation of intagibles based on profit projections. *See* OECD, *BEPS Action 8 – Implementation Guidance on Hard-to-Value Intangibles (public discussion paper)* (OECD, 23 May-30 June 2017).
26. *See* Musselli & Musselli, *supra* n. 21. The OECD TPG are not a source of law and so they often provide for more than one rule, allowing states to choose which one to introduce in their legal system.
27. Independent parties can also be wrong about projections, but they are subject to the positive or negative consequences of their "mistakes".
28. The tax rate on income determines what share of the profits each state is entitled to.
29. Consider, for instance, the *Amazon* case, analysed later at *infra* n. 69, and how complicated it was to give a value to a buy-in payment. The case cost millions of dollars to litigate, featured 30 expert witnesses battling one another, and was decided through a US Judge opinion that was more than 200 pages.

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3.3. Missed opportunity by the OECD and its member countries to enforce clearer rules and arbitrated rulings on intangible valuations

Has the BEPS Project improved the situation? No, in the author's opinion, it has not, and many authors and parties in the business community share his opinion.[30] In particular, firms[31] are concerned that repeated reference in BEPS documents to group integration, interdependencies (such as reputational interdependence), synergies and value chain analyses may lead to transfer pricing allocations being based on vague, subjective notions of relative contribution, completely removed from the market.

BEPS rules may thereby allow different countries to proceed in their own preferred direction in terms of interpretation, implementation and enforcement. The rules thus open the door to unprincipled and aggressive tax agents and to an increase in multilateral tax disputes with no clear path to resolution.[32]

Furthermore, the author believes that the OECD TPG, following BEPS, make the rules even less predictable, since they state that intangible ownership (which is the main profit driver) is the result of another subjective assessment aimed at judging the "importance" of intangible-related functions performed by the parties. What is important for one tax administration might not be important to another.

With regard to rulings, in practice, each country (or the strongest among them) wants to retain its sovereignty over fiscal matters and does not accept losing its power to set its tax base, for example, through arbitrated proceedings. Governments will continue to claim that they are fighting tax-evading multinationals that are illegally shifting profits to tax havens. Conversely, firms will continue to respond by being fully tax compliant. Harsh litigation and double taxation by virtue of misapplication of the arm's length principle or of unilateral[33] taxation implemented by individual countries might arise.

Although the ALP is becoming increasingly accepted, it is often not clear whether or not the correct rule has been applied to a specific transaction of a single firm until years later.

30. Many authors and those in the business community who commented on the OECD changes share the conclusion of this article, *see* OECD, *supra* n. 4, in particular the authors and practitioners quoted in *infra* n. 74 and n. 76.
31. Id., comment of Business Europe, which is the most important association of European companies.
32. *See* M. Herzfeld, *The Case against BEPS – Lessons for Coordination* 1 (2 Aug. 2017), available at https://ssrn.com/abstract=2985752. *See also* A. Musselli & A. Musselli, *Rise of a New Standard: Profit Location in Countries of Important Intangible Functions Managers*, 24 Intl. Transfer Pricing J. 5 (2017), Journals IBFD.
33. C. HJI Panayi, *International Tax Law Following the OECD/G20 Base Erosion and Profit Shifting Project*, 70 Bull. Intl. Taxn. 11, p. 658 (2016).

4. Commercial Rationality of Research Acquisitions and Loans in Capitalist Economies in True Bargaining Contexts

4.1. Does the lack of control over a research activity make the research acquisition commercially irrational?

The focus of this article is on a comparison between a research acquisition and a loan under the conditions of Example 17. When the purchaser of research lacks the ability to monitor its development, the OECD TPG state that the contract differs from what would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances.[34] The conclusion in Example 17 is that the purchase of the research (where it is not rational from a commercial perspective) should be recharacterized as a loan (judged commercially rational).

As mentioned previously, this article does not focus on the minimum structure that is required in order to avoid the company being challenged as a "cash box" without substance. Having previously simplified this problem, the assumption is that the funder of the research has the required substance.[35] The focus is instead on the notion of "control over intangible-related functions" and on answering the following questions:
– given Example 17, is the matter truly as the OECD affirms, i.e. that the research purchase is commercially irrational if the buyer lacks the ability to control the research activity; or
– is the OECD changing the ALP just to change the main driver of the location of intangible returns?

34. Commercial rationality is described in new para. 1.122 of the OECD TPG (2017), *supra* n. 1, introduced in 2015 by the BEPS Project (*see supra* n. 6):
    The transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction. It is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a pre-tax basis since this may be an indicator that the transaction viewed in its entirety lacks the commercial rationality of arrangements between unrelated parties.
35. The author now shares the opinion of Barnes et al., *supra* n. 4, who affirms (at p. 634 et seq.):
    An example might help crystallize thinking and provide needed clarity about this key issue. Assume that highly-taxed parent company (P) capitalizes lightly-taxed subsidiary (S). Following good corporate governance practices, S makes the decision to hire and fund an affiliate (A), with its "best in class" research team, to pursue "blue sky" biologics R&D for the account of S. S has the capability to monitor and assess A's activities at a fairly high level, similar to the level of monitoring performed by a corporate Board of Directors, and in fact does so, but the operational aspects of the R&D project are managed by A in consultation with more senior executives at P who direct and oversee the formulation of global R&D strategy for the group as a whole […] We do not believe that the tax inspector in either jurisdiction should be authorized to disregard the capitalization of S, or to treat A and/or P as the residual profit-taker, or to choose non-recognition if that approach benefits the government.

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The conditions underlying the facts of Example 17 include competition in the target market of the investment, a high level of risk of the development, already at an early stage, and competition among segmented function providers. It was shown that, in this scenario, the (formal) role of the residual claimant, and subsequently which contract is established, i.e. a loan or purchase, is theoretically irrelevant in making changes to the parties' remuneration. The funding party (S) assumes the risks of the development under both contracts and is the real residual claimant, with a large positive or negative variable remuneration.[36]

New assumptions will now be introduced to analyse the true bargaining context and to draw more "sophisticated" conclusions. Some concepts are extracted from contract theory, which focuses on agreements providing incentives for independent parties to exploit prospective gains arising from cooperation.[37] In true bargaining contexts, one party often has more or better information than the other (i.e. information asymmetry) about their actions or business results.

Various problems can arise when the research purchase contract is negotiated among independent parties. If the (independent) funder is not able to monitor the research activity, a problem arises with regard to the incentivization of the research developer because the positive result of the project is also linked to his behaviour and performance.

The research provider (party A in Example 17) would have no incentive to perform an efficient service in situations in which his remuneration is set at a fixed market rate and the funder (party S) has no managerial structure to control the service provided. Party A, after signing the contract, would choose a low-effort development (moral hazard), which is less harmful to his utility but makes it more likely that the research project will have poor results. S would not be able to monitor a breach of the contract and apply a consequent penalty and would suffer damage (a lower expected value) leading to an increased likelihood of a bad result due to A's moral hazard.

The countermove by S would simply be to set an appropriate remuneration for A linked to the success or failure of the research project. A higher remuneration of comparables (i.e. the third quartile value) should be linked to the success of development of the intangible, while lower remuneration of comparables (i.e. the median value) should be linked to its failure.Such an incentive is aimed at aligning the interests of A with those of S, both of which are best remunerated when obtaining a good result. This is the best solution to enforce among affiliates in order to mimic what independent parties would agree to in comparable circumstances.[38]

4.2. Credit rationing and the provision of collateral by borrower

Problems may arise under a loan contract granted to A by S, the two being independent parties, when assumptions are made that are closer to the true bargaining context (still under the conditions of Example 17). These problems are more serious than those arising in respect of a purchase of the research and an adjustment to the loan contract is possible only when A is able to secure the borrowed sums.

The fundamental problem in setting up a loan by S to A is that, in capitalist economies, the credit access of an entrepreneur depends mainly on his wealth (assets). In this instance, there is an asymmetry in terms of the information available to the lender (who knows less) and the borrower (who knows more) in terms of the borrower's behaviour and investment result. In actual credit markets, credit rationing may also impact lending, meaning that a lender might be unwilling to lend additional funds to a borrower even at a higher interest rate and thus the extra credit demand will not be satisfied.[39]

Lenders are not willing to raise the interest rate (thereby reducing excess demand) over a given value because a further increase may lower their expected profit, due to the lower probability of the amounts being paid back. This happens because, when an increase in the interest rate is proposed, borrowers may choose riskier projects (moral hazard) and potential borrowers with less risky projects may be discouraged from seeking a loan (adverse selection).

When it is not possible to raise the interest rate, loans may nevertheless be granted in respect of risky projects if assets of the borrower are pledged as security (collateral). If the borrower fails to make his repayments, the lender can foreclose on the collateral, selling it to recover

36. Note the relevance of the residual claimant role at secs. 2.6. and 3.1. of this article and *supra* n. 16, in the context of periodic adjustment of intangible prices.
37. The theory requires the analysis of partial models that take into account the full complexity of strategic interactions between privately informed agents in well-defined settings. *See* B. Salaniè, *The Economics of Contracts* (2nd ed., MIT Press 2005), Introduction. For general handbooks on contract theory and principal-agent models, *see* J.-J. Laffont, *The Economics of Uncertainty and Information* (MIT Press 1989); Salaniè, *supra*; and A. Nicita & V. Scoppa, *Economia dei contratti* (Carocci 2005). These books do not use complicated mathematic symbols but rigorously maintain the original concepts.
38. *See* A. Musselli, *Intangible Revenues Assigned to the Developer and Not to the Funder Lacking "Development Monitoring Staff": OECD Transfer Pricing Anti-Abuse Rule Clashes with Economics of Contracts*, 43 Intl. Tax J. 6, p. 43 et seq. (2017); here, the author also analyses the credit rationing but without the "adjustment" of the loan securitization. Concerning the reasons for group integration, *see* the pivotal work of R.H. Coase, *The Nature of the Firm*, 4 Economica 16, New Series, pp. 386-405 (Nov. 1937) and, concerning agency costs, O. Williamson, *The economics of organisation: the transaction cost approach*, American Journal of Sociology LXXXVII (1981). Note that inside groups there are no problems of moral hazard because there are no shareholders of S who are in a conflict of interest with shareholders of A because S and A are part of the same group.
39. The most influential paper on the argument is still Stiglitz & Weiss, *supra* n. 2. Stiglitz won the Nobel Prize in 2001 for studies on information asymmetry in credit (and labour) markets. For the relevance of collateral in mitigating the credit rationing of risky projects, *see* T. Steijvers & A. Voordeckers, *Collateral and credit rationing: a review of recent empirical studies as a guide for future research*, 23 J. of Economic Surveys 5, pp. 924-946 (2009); C. Atanasova & N. Wilson, *Disequilibrium in the UK corporate loan market*, 28 J. of Banking and Finance 3, pp. 595-614 (2004); and L. Menkhoff, D. Neuberger & C. Suwanaporn, *Collateral-based lending in emerging markets: evidence from Thailand*, J. of Banking and Finance 30, pp. 1-21 (2006).

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the sum lost. The risk of the operation for the lender is, therefore, reduced or totally absent (if the loan is completely secured). Where the loan is risk free, the interest rate may be set at a market rate.

Many recent authoritative theoretical and empirical studies, aimed at analysing the increase in income inequality[40] among individuals in capitalist economies, confirm, inter alia, the relevant rationing of credit access, especially for risky projects, when borrowers are not able to provide collateral. This credit rationing is further exacerbated when the conditions of Example 17 hold, i.e. when the financing must be used for a high-risk investment at an early stage of development.[41] Stiglitz (2014), one of the most influential economists and winner of the Nobel Prize, recently affirmed:[42]

> We provide a bare-bones model that we think may capture more accurately what has been going on than any of the models presented so far: *the banking system provides credit based on collateral*. [Emphasis added.]

Fan et al. (2016) observed that:[43]

> Our theoretical model also implies that banks will ration potential franchisees with too little collateral. In other words, in our model, *collateralizable housing wealth affects franchisors' organizational choices* not only through its effect on the effort of franchisees who are qualified to get a loan, but also via the number of potential franchisees who are qualified to get a loan, both due to the same underlying incentive problem. [Emphasis added.]

De Nardi and Fella (2017) noted:[44]

> However, *the borrowing constraint limits the size of the firm and entrepreneurs must partly self-finance any additional investment*. [Emphasis added.]

And, finally, Mookherjee (2002) remarked that:[45]

> In the presence of limited liability, moral hazard problems give rise to credit constraints for poor agents: they obtain positive but limited access to credit. *Credit access depends on the wealth of borrowers, which defines the amount of collateral they can post*. [Emphasis added.]

Considering that venture capital entities can compensate for market failures and easily supply vast amounts of financing to "innovative" researchers, Audretsch et al. (2011) note that:[46]

> Venture Capital (VC) investors typically fund US dollars 5–10 million investments and syndicate out larger investments, *but the risk capital and coordination costs involved in funding US dollars 250 million ... may be too great for VC investors, even if the projects have positive net present value*. [Emphasis added.]

It appears highly unlikely, in a capitalist society, that an (independent) company, hiring only a team of researchers and without any collateral would obtain a relevant loan from an (independent) capital-rich company (acting as a bank) to finance a high-risk investment at an early stage in a competitive market.

In conclusion, in the context of Example 17, it is likely that the loan would not be granted by S to A, the two being independent parties, as long as A lacks the collateral to secure the borrowed sum. In any event, to secure a loan, the interest rate (adjusted for risk) would have to be so high (100% in the previous, hypothetical, example) that the discussion concerning recharacterization of the research purchase as a loan would be completely in vain because regardless of which of the two contracts is in force, the (actual) residual claimant of revenue would always be S, as shown herein.

The result would be different only if, in the context of Example 17, A were to provide collateral to secure the loan. A becomes the residual claimant of the gains or losses of the project because he puts his capital at risk (S no longer does so). Changes in respect of A are not due to his ability to control the research activity but to his putting his own capital at risk. Example 17 does not make reference to the fundamental assumption of the loan securitization. In any event, the assumption is not able to substantiate the mandatory recharacterization of the research purchase as a loan. However, it at least makes the loan possible.

4.3. Contracts that comply with the ALP in the context of Example 17

In the context of the facts implied in Example 17,[47] when the buyer of the research service is not able to control the researcher's activity, both contracts, at arm's length, imply the following:

- assuming there is an (adjusted) research purchase by S and appropriate market remuneration is established for A: when A is not able to control the research activity, the right adjustment is not recharacterization as a loan; the adjustment is to link A's remuneration to the success or failure of the research project – higher remuneration of comparables (i.e. the third quartile value) should be linked to the success of the intangible development, while lower remuneration of comparables (i.e. the median value) should be linked to the failure of the intangible development. Thus, S will be the residual claimant of gains or losses of the project after having paid A for his service; and
- assuming there is an (adjusted) loan by S and A is able to pledge assets as security (collateral) for the financing: A becomes (formally and actually) the residual

40. A book that had great success in terms of its analysis of the growth of income inequality between workers and capitalists is T. Piketty, *Le Capital au XXI siècle* (Editions du Seuil 2013). The author quotes other papers as well, which are less known, but were published earlier than Piketty's book.
41. As shown before (using a simplified numerical example), assuming a high expected loss (loss of 100% of capital with 50% probability) and certain other conditions, an interest rate of 100% is sufficient only to reach an expected profit of zero for the lender.
42. Stiglitz, *supra* n. 3, at p. 39.
43. Y. Fan, K. Kuhn & F. Lafontaine, *Financial Constraints and Moral Hazard: The Case of Franchising*, University of Dusseldorf Institute for Competition Economics, Discussion paper 223, p. 3 (2 June 2016).
44. De Nardi & Fella, *supra* n. 3.
45. Mookherjee, *supra* n. 3.
46. D. Audretsch, O. Falck, S. Heblich & A. Lederer, *Handbook of Research on Innovation and Entrepreneurship* 100 (Edward Elgar Publishing 2011). In any event, venture capitalists remain largely in the position of residual claimants.
47. These are: investment at an early stage in a competitive market with a high degree of risk and competitive markets of lenders and research providers.

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claimant of the project's results, assumes the related risks and receives remuneration that is significantly variable. S receives interest at a rate adjusted for the low-risk loan. Example 17 does not explicitly mention the loan securitization or the borrower's creditworthiness, but this assumption is fundamental (if the loan is not secured, it will simply not be granted).

Under the conditions of Example 17, either of the two adjusted contracts complies with the conditions that independent parties would agree upon and either is commercially rational, provided that the contract is agreed to before the parties acquire knowledge of events that determine the actual results.[48] In these circumstances, the recharacterization of one contract (i.e. the purchase of the research) as the other (i.e. the loan) would be inappropriate and would not comply with the ALP.

In conclusion, it is only possible to assess the commercial rationality of one contract versus another by undertaking a case-by-case ALP assessment of the risks borne by the capital of the affiliates. This includes assigning a market-comparable return to capital that does not participate in the risks of the whole business activity and any residual profit or loss to the capital that does bear the risks of the whole activity.

5. Juridical Enforcement of a Contract Recharacterization on the Basis of a "Lack of Control of Intangible-Related Functions"

5.1. The power to recharacterize contracts within the ALP framework: A primer

The OECD TPG allow for a transaction to be "disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances".[49]

If the context differs from that of Example 17 and if it is assumed that A is the sole owner of a valuable intangible as a result of past investment and risks assumed, the conclusion of the example will be partially accurate.[50] In this scenario, one option to apply the ALP is to recharacterize the research purchase as a loan. A should be the (formal and actual) residual claimant as the intangible owner, while S should be remunerated at an interest rate adjusted for (low) risk.[51] Another option would be for S, before paying for the ongoing research, to pay for the cost of the highly valuable intangible that has already been developed by A.[52] These conclusions, however, have nothing to do with the lack of control over intangible-related functions by S.

Subsequently, it is important to analyse the juridical framework for recharacterizing a transaction, not on the basis of risks borne by the capital of affiliates, as should be the situation under the ALP, but on the basis of a "lack of control over intangible-related functions", as recommended by the new OECD TPG.

The legal status of the OECD TPG as a primary means of interpretation of the ALP is questionable. A tax administration, wanting to recharacterize a transaction on the basis of a lack of control over intangible-related functions when that country has not incorporated such a measure into domestic law, will encounter significant difficulties. It is impossible to substantiate that a lack of control, on its own, implies that the behaviour of the parties is commercially irrational. The economics of contracts and authoritative empirical studies support just the opposite.

Instead, what would happen if a domestic anti-abuse provision, based on a lack of control over the function of intangibles, were to be enforced in a country? The majority of countries have signed tax treaties including a provision modelled after article 9 of the OECD Model, which means they have agreed to the ALP.

Therefore, even if a country's domestic law recharacterizes a transaction based solely on a lack of control, the transaction cannot be recharacterized because (i) this would be contrary to article 9 of any treaty based on the OECD Model and to the provisions of international tax treaties (in the majority of countries) that prevail over domestic rules and (ii) a lack of control, in itself, does not qualify the behaviour of the parties as irrational.[53]

6. Concluding Remarks

This article has examined, in particular, the following scenario that would fall within the scope of Example 17 (on intangibles) of the OECD TPG: a research investment is made, at an early stage, in a competitive market, that involves a high degree of risk and competition amongst

48. This fact implies that the risk is current and not over.
49. Para. 1.222 OECD TPG (2017).
50. Consider the previous example. If the expected value of the investment is assumed to be +5,000 (possible results are +11,000 and -1,000 with 50-50 odds) and the "owner" of the project is A, given his past investments and assumed risks, the recharacterization of the ongoing research purchase as a loan could be appropriate. One can also assume that S buys the intangible, but he must pay the "full" market value of 5,000.
51. Further investment by S must be assumed, subject to a low degree of risk because, conversely, a share of potential residual profits or losses pertains to the same S.
52. Rather than recharacterizing it, the transaction should first be *repriced* following the ALP. *See* M. Pankiv, *Post-BEPS Application of the Arm's Length Principle to Intangibles Structures*, 23 Intl. Transfer Pricing J. 6, p. 474 (2016), Journals IBFD.
53. The author, following discussion with and valuable comments from Pankiv, now supports this conclusion. *See also* M. Pankiv, *Contemporary Application of the Arm's Length Principle in Transfer Pricing* (IBFD 2017), Online Books IBFD. R. Hafkenscheid, in *The BEPS Report on Risk Allocation: Not So Functional*, 24 Intl. Transfer Pricing J. 1, p. 23 (2017), Journals IBFD, concerning the United States, affirms that he "doubts whether the Internal Revenue Service, the US federal tax authority, will apply the interpretation [introducing the notion of control over intangible-related functions] in accordance with its objective. Second, the author doubts whether local courts will follow the revised interpretation, resulting in more controversy between taxpayers and tax authorities". *See also*, in respect of the US and Canadian Courts, respectively, G.D. Sprague, *'Special Measures' and the Arm's-Length Principle*, 43 Tax Mgt. Intl. J. 1 (2014); J. Andrus & P. Oosterhuis, *Transfer Pricing After BEPS: Where Are We and Where Should We Be Going*, Taxes – The Tax Magazine 3 (2017) and N. Boidman & M. Kandev, *BEPS cash box inconsistent with Canadian tax rules*, 24 Canadian Tax Highlights 10 (2016). Concerning the limited interpretative role of the OECD TPG, *see* G. Liaugminaite, *Recognition of the Actual Transactions Undertaken*, 17 Intl. Transfer Pricing J. 2 (2010), Journals IBFD.

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lenders and research providers. In this scenario, it would be inappropriate to recharacterize a research purchase as a loan, simply on the basis that the buyer lacks the ability to control the research activity, based on the applicable transfer pricing rule, which requires that the transaction reflect the conditions that independent parties would agree upon (the ALP).

According to the economics of contracts, this recharacterization would have the effect of changing a widely used type of contract, which is actually used between independent parties, into a form of contract that is rarely used (or is non-existent) among independent parties. Given the conditions of Example 17, a loan granted by a capital-rich entity (S) to a research provider (A) that has no collateral is simply unlikely because of credit rationing. This conclusion is supported both on a theoretical basis and has grounding in recent empirical studies.

Furthermore, given the assumptions of Example 17, shifting the focus to the loan does not solve the problem. Setting an appropriate interest rate, adjusted for risk, would make any discussion concerning the recharacterization of the research purchase as a loan moot because regardless of which of the two contracts is in force, the (actual) residual claimant of revenues would always be the research funder (S). This holds true, obviously, if the interest rate is correctly calculated given the conditions of Example 17 and the ALP is not breached in setting the interest rate in respect of low-risk loans.

The loan could be granted only if the research performer (A) were to provide collateral for his securitization; he would become the residual claimant of the gains or losses of the project, but this would be not be due to having control over the research activity, but to the fact that he has put his own capital at risk. Example 17 does not mention[54] loan securitization and this, in any event, does not substantiate the contract recharacterization but instead makes the loan an allowable option.

The recharacterization of one type of contract as another under the OECD TPG, not only in Example 17 but generally, when this is based on a lack of control over intangible-related functions, does not mimic the behaviour of independent parties, meaning that it is not compliant with the ALP in terms of fundamental issues, such as entitlement to ownership of an intangible and intangible-related revenue.[55]

When the funder of the research project (S) lacks managerial control over an activity of the service provider (A), the appropriate adjustment, necessary to comply with the ALP, does not imply recharacterizing a contract. The solution is simply to establish variable remuneration for the provider (A) that is linked to the success or failure of the project and still based on market comparables.[56] Higher remuneration of comparables (i.e. the third quartile value) should be linked to the success of the development of the intangible, while lower remuneration of comparables (i.e. the median value) should be linked to a failure to develop the intangible.[57]

It would be a completely different matter if the investment project was expected to have a significant positive value (with low risks) and the current research provider (A), as a result of past investment and risks assumed, had a monopoly on developing the project. In this instance, the purchase of the research (at a market price) by the funder (S) would not be in compliance with the ALP. The research purchase contract would shift value (in breach of the ALP) from the service provider (A), who is already the intangible's owner, to the research buyer (S). An allowable option would be for (S), the research funder, in addition to paying for the ongoing research, to pay for the highly valuable intangible already developed by the research provider (A).

A second option, to be applied in particular if the intangible sale is difficult to evaluate, would be to recharacterize the research purchase as a loan to the research provider; the lender would have a fixed market remuneration (interest rate for low-risk loans), while the service provider (owner of the intangible) would remain the residual claimant of the business results. In these circumstances (which are different from those of Example 17), the repricing or recharacterization of transactions is appropriate regardless of whether the funder has the ability to control the research activity.

The recharacterization of a contract based on more appropriate terms has nothing to do with a lack of control, by the funder, over the service provider's activity (or, more generally, a lack of control over intangible-related functions),[58] as depicted in the OECD TPG 2017.

54. *See supra* n. 15.
55. The OECD has affirmed that the new measures confirm the ALP and only avoid abuses, but the OECD's mandate included the possibility of enforcing special measures that extended beyond the principle. *See* the Executive Summary in the *Actions 8-10 Final Report*, *supra* n. 6. The author believes (as do many others, *see infra* n. 74 and n. 76) that the OECD is establishing measures that extend beyond the ALP, despite the OECD's assertion.

56. For the notion of a comparable, *see supra* n. 5.
57. *See* Musselli, *supra* n. 38, and the literature on principal-agent models quoted in that article, as well as in n. 35.
58. Some authors already expressed doubt in 2010 concerning the compatibility of the ALP with the notion of control over risk when para. 9.23 of ch. IX of the OECD TPG (2010) was published. The OECD TPG (2010) defined "control" over risk as (i) "the capacity to make decisions to take on the risk (decision to put the capital at risk)" and (ii) "decisions on whether and how to manage the risk, internally or using an external provider". *See* A. Musselli & A. Musselli, *Observations on OECD Discussion Draft on Business Restructuring: Is the Notion of Control over Risk at Arm's Length?*, 16 Intl. Transfer Pricing J. 4 (2009), Journals IBFD. In respect of the author's criticism of the new notion "of control over risk", *see* the following opinions included in OECD, *supra* n. 4:
    (1) KPMG International: "Separation of Risk From Decision Making: The Discussion Draft often takes the position that the assumption of risk is not separable from control over risk at arm's length. This is simply inconsistent with observed arm's length business arrangements. While a certain level of expertise is needed to evaluate whether or not a risky investment should be made, this is very different than exercising detailed control over how this investment is made and managed for the very simple reason that the expertise needed to manage the investment may lie with another company. […] Some common examples include: The fact that logistics is critical to the success of many different types of business operations does not prevent a number of very sophisticated and competent companies from outsourcing their logistics to specialized logistics companies such as Federal Express, UPS and DHL"; and
    (2) Barnes et al.: "A typical investor in the marketplace controls and manages investment risk by deciding how much to invest, in what,

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The recharacterization requires a case-by-case assessment (one size does not fit all) and depends on factors that affect conditions that independent parties would agree upon. The ALP assessment is based on the risks borne by the capital of affiliates. This complies with the principle that a market-comparable return should be assigned to the capital of affiliates that do not participate in the risks of the whole business activity, and any residual profit or loss to the capital of affiliates bearing the risks of the entire activity (residual claimant role).

From a juridical perspective, the force of the OECD TPG as a primary means of interpretation of the ALP is questionable. Consequently, in the author's opinion, a country's tax administration, aiming to recharacterize a transaction based on a lack of control over intangible-related functions when that country has not incorporated such a measure into its domestic law, will encounter great difficulties. It is impossible (as shown) to substantiate that the said lack of control, on its own, demonstrates commercial irrationality in terms of the parties' behaviour. The economics of contracts and authoritative empirical studies support the opposite view.

Similarly, if the domestic law of a country provides for the recharacterization of a transaction simply on the basis of a lack of control and article 9 of a tax treaty (mirroring the OECD Model) applies to the transaction, the transaction cannot be recharacterized. The provisions of the tax treaty (in the majority of countries) would prevail over domestic law and a lack of control, on its own, does not qualify as irrational behaviour of the parties.

In 2015, the primary goal of the BEPS Project was to counter abuse, especially in the context of controversial cases involving giant "web" firms operating as monopolies, shifting their tax bases to low-tax countries, which constituted a real (or in some cases purported) breach of the ALP. Abuse by multinationals is, at present, the greatest concern of the OECD.

There is a nearly endless amount of literature on tax avoidance and (real or purported) evasion via transfer pricing.[59] The OECD is convinced that, for multinationals, it is "too easy to shift capital to a low tax jurisdiction and earn returns there without being subject to 'proper' tax levels" and that the tax administrations (of high-tax countries) will never be able to alleviate the disadvantage regarding business information that they have relative to firms. In contrast, many are convinced that the ALP, prior to the changes relating to BEPS, was sufficient to avoid abuses, provided that tax administrations conduct efficient audits.[60]

The OECD has labelled the funding of intangible development in exchange for property ownership as automatically abusive and in breach of the ALP when the funder has no capability to monitor the development of the activity. This new general anti-abuse rule is enforced without requiring an actual assessment of the existence of abuse, thereby banning not only abusive behaviour, but also behaviour complying with the ALP.[61]

What the OECD might have forgotten is the lesson that market economies are driven by incentives "given" to a multitude of independent agents who act (without coordination) to maximize their own benefits. It is worth reiterating that the financial bubble that burst in 2008 was supported, in part, by incentives given to the economic agents who caused the bubble.

In the short term, the notion of control over intangible-related functions can favour highly industrialized countries that have an educated workforce able to manage intangible projects. In the medium and long term,[62] however, the ALP only incentivizes firms to relocate key managers of intangible development to low-tax countries,[63] which will negatively impact the public budget of high-tax countries.

Relocating the managers of an intangible project, for instance, to a Bermuda affiliate is objectively difficult (though not impossible), but it is less difficult to relocate

on what terms, and for how long. Many investors don't have meaningful control beyond these matters, yet no one questions their right to the full residual return".

59. Abuse (or purported abuse) via transfer pricing is really an "old story" and so much has been written about it already that a few words here are enough. In recent years, abuse has arisen especially, as described herein, in respect of the valuation of intangibles through projections of future profits generated by their use, during property transfers or buy-in payments in the context of cost sharing agreements. Amongst the vast literature on the recent cases concerning Apple, Starbucks and others that used the double Irish-Dutch sandwich (popular among US companies) to lower their global tax rate, *see*, for instance, M. Brittingham & M.St.J.R. Butler, *OECD Report on Base Erosion and Profit Shifting: Search for a New Paradigm or Is the Proposed Tax Order a Distant Galaxy Many Light Years Away?*, 20 Intl. Transfer Pricing J. 4 (2013), Journals IBFD; C. Fuest et al., *Profit Shifting and "Aggressive" Tax Planning by Multinational Firms: Issues and Options for Reform*, 5 World Tax J. 3 (2013), Journals IBFD; H.T.P.M. van den Hurk, *Starbucks versus the People*, 68 Bull. Intl. Taxn. 1 (2014), Journals IBFD. For literature on anti-abuse measures or against tax havens, starting from the US IRS White Paper in 1988, *A study of Intercompany pricing under section 482 of the Code*, Notice 88-123, 1988-2 CB.485 (18 Oct. 1988). *See*, for instance, J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer 2010). Controlled foreign corporation rules target tax havens in particular. *See* R. Avi-Yonah & O.S. Halabi, *US Subpart F Legislative Proposals: A Comparative Perspective*, Law & Economics Working Papers, Paper 69 (2012), available at http://repository.law.umich.edu/law_econ_current/69.

60. R. Tremblay & A. Nawaz Nanji (whose comment is included in OECD, *supra* n. 4):

    The OECD's answer appears to be because it is now considered too easy to shift capital to a low tax jurisdiction and earn returns there without being subject to "proper" tax levels. But does it really make sense to subvert the determination of AL (arm's length) terms and conditions in order to overcome defects in country tax laws? Of course not. This is a slippery slope that will likely lead to unforeseen unwelcome consequences. For example, what will happen if taxpayers do shift the SPFs (significant people functions) to low tax jurisdictions and capital is provided by the high tax ones? Will the system have to be rejigged yet again – back to the ALP?

    Others are convinced that the pre-BEPS rules were sufficient to avoid abuse on the condition that efficient audits were managed by tax administrations. *See* OECD, *supra* n. 4; *see also* Barnes et al., *supra* n. 4, at pp. 645-646: "Speaking from our experience, current rules are almost always sufficient to address aggressive transfer pricing conduct *provided* that sufficient skilled resources are directed to the effort".

61. *See* Musselli, *supra* n. 38, at p. 48.

62. The author accepts the objection that "In the long run we are all dead" (J.M. Keynes), but still believes that providing wrong incentives is counterproductive.

63. *See also* J.J. Fichtner & A.N. Michel, *The OECD's Conquest of the United States: Understanding the Costs and Consequences of the BEPS Project and Tax Harmonization*, Mercatus Research, Mercatus Center at George Mason University, Arlington, VA (Mar. 2016).

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such managers[64] who are well remunerated (and taxed) to a "neighbouring" country[65] (still unidentified)that has reduced its business income tax rates.[66]

The BEPS Project missed a fundamental opportunity to establish more predictable rules for intangibles operations,[67] in respect of which reliance on data (profit) projections is the main factor for an ALP assessment. In this scenario, tax administrations are at a significant disadvantage with regard to information on profit projections, relative to firms, and this can lead to the suspicion that such firms will only disclose information that leads to a decrease in their tax rate. Introducing clearer rules on the valuation of intangibles and, in particular, mandatory and arbitrated rulings (or income adjustments) between companies and conflicting tax administrations[68] would have really contributed to dispelling this suspicion and ending the never-ending discussions on value. It would have helped to guarantee a balance between the interests of countries.[69]

Conversely, in approving the BEPS Project in 2015, the OECD made the rules less predictable because, in addition to references to uncertain concepts like group integration, interdependencies, synergies and value chain analyses, there is now also a reference to a subjective assessment related to the "importance" of intangible functions performed by parties. What might be important for one tax administration would not necessarily be important for another.

At a time when public budgets are facing difficulties, many believe that the BEPS rules allow for different countries to proceed in their own preferred directions in terms of interpretation, implementation and enforcement. This opens the door to unprincipled and aggressive tax agents and to an increase in multilateral tax disputes with no clear path to resolution.[70]

64. Also if "economically" there would be no need to replace the managers.
65. Consider that, in 2011, the Microsoft group had 1050 employees in Ireland. Which country will play the role of Ireland for US multinationals in the future? Maybe this is no longer the right question because, in the future, (from Jan. 2018) the United States will become a "low-tax country" as a result of President Trump cutting the tax business rate from 35% to 21%.
66. Historically, the OECD TPG explicitly allowed for income tax competition between states, which has been reiterated in the 2017 version although with less emphasis. Para. 9.182 OECD TPG (2010) stated: "Provided functions, assets and risks are actually transferred, it can be commercially rational from an Article 9 perspective for a Multinational Enterprises group to restructure in order to obtain tax savings". Para. 9.182 was deleted in 2017, but paras. 9.34 and 9.38 still exist: "In making commercial decisions, tax considerations may be a factor" (para. 9.34) and "The presence of a tax motive or purpose does not of itself justify non-recognition of the parties' characterisation or structuring of the arrangement" (para. 9.38).
67. Mainly intangible operations, like intangible transfers, intangibles in sequence or buy-in payments.
68. Baistrocchi (as well as the author) supports bilateral advance pricing agreements not only in limited cases concerning the value of intangibles (E. Baistrocchi, *The transfer pricing problem: a global proposal for simplification*, 59 The Tax Lawyer 4, pp. 941-979 (2006)). The arbitration clause to relieve double taxation that the OECD supports is not widely accepted. In fact, only 27 countries, most of which are party to the Arbitration Convention (Convention 90/436/EEC of 23 July 1990 on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, OJ L 225 (1990), EU Law IBFD), being EU Member States, have opted for the arbitration clause to relieve double taxation as determined in *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (24 Nov. 2016), Treaties IBFD, signed in Paris on 7 June 2017. *See* http://www.oecd.org/tax/treaties/MLI-frequently-asked-questions.pdf.
69. The Amazon case shows the complexity of setting an appropriate transfer price for intangible transfers through profit projections. In the following, the author has simplified the group structure and actual facts. Some years ago, Amazon incorporated a Luxembourg affiliate (Luxco) with the goal of selling in European markets. Luxco had to pay a buy-in to its US affiliate (USco) for the use of some US intangibles and had to participate in future intangible investments related to European markets through a cost sharing agreement. In doing so, Luxco became the owner of Amazon intangibles for Europe, paying a buy-in of USD 254 million and participating in ongoing expenses via cost sharing. During an audit of the transaction, years later, the IRS discounted the cash flow of actual European sales (and profits) in valuing the buy-in, while the company based its value, also years before, on a comparable independent transaction (CIT). The difference between the amount calculated by Amazon (USD 254 million) and the amount calculated by the IRS (USD 3.5 billion) was huge. Harsh litigation ensued between Amazon and the IRS. A US Tax Court decided on 23 Mar. 2017 that the method used by the IRS was arbitrary while that used by the company was appropriate subject to some upward adjustments (such as the arm's length buy-in, estimated at nearly USD 500 million). Was the buy-in paid by Luxco in the amount of USD 254 million really appropriate for the intangibles already developed by USco, and did the European investments via cost sharing, by Luxco, bear any further risk? Assuming that the Luxembourg financing and buy-in was aimed at starting an innovative project with an expected value = 0 and with relevant risk, the decision to calculate the value of the buy-in using actual sales is not appropriate (actual sales do not provide an appropriate measure of the assumption of risks); instead, the decision was the opposite (so it was allowed to include actual sales in calculating the buy-in) assuming the Luxembourg project started from a highly valuable intangible property already in existence, due to the previous investments of USco. It is arguable that only information available at the moment of the buy-in should be used, subject to a true-up years later in a manner that only reconsiders what information was available before. On the Amazon litigation, *see*, for example, R. Avi-Yonah, *Amazon vs. Commissioner: Has Cost Sharing Outlived Its Usefulness?*, Public Law and Legal Theory Research Paper Series Paper No. 551, Law & Economics Research Paper Series Paper No. 17-003 (2017). Furthermore, other European countries also challenged Luxco transfer prices, obviously not in respect of intangibles but on the distribution side, affirming that the company used "hidden" permanent establishments (in the country of sales), which had to be adequately remunerated. France, Germany, Italy and Spain wanted digital multinationals like Amazon to be taxed in Europe based on their revenues, rather than only on profits (*see France, Germany, Italy, Spain seek tax on digital giants' revenues*, Reuters (9 Sept. 2017), available at https://ca.reuters.com/article/businessNews/idCAKCN1BK0HX-OCABS). In Italy, a challenge was made in Apr. 2017 by the Revenue Agency amounting to EUR 130 million of purported tax avoidance for the 2009-2014 tax years. The company responded that they were fully tax compliant. Finally, in Oct. 2017, the European Commission, under another profile, took the position that the Amazon Group had received State aid from Luxembourg, given the "harmful" low taxation in that country and the "purported" damage to other EU Member States, in the amount of EUR 250 million; The Commission is now asking Luxembourg to recover those taxes from one of the Amazon Luxembourg affiliates. On this last aspect, supporting the fact that the challenge is not grounded with regard to US tax deferral, *see* R. Tavares, B.N. Bogenschneider & M. Pankiv, *The intersection of EU state aid and U.S. tax deferral: a spectacle of fireworks, smoke, and mirrors*, 19 Florida Tax Rev. 3, p. 121 (2014). In conclusion, the author observes that only one of the following four hypotheses is a true fact for Amazon's European business:
    - Amazon did not breach any rule regarding intangibles (in the United States) or on the distribution side (in European countries);
    - Amazon breached the rules on intangibles, but not on distribution;
    - Amazon breached the rules on distribution, but not on intangibles; or
    - Amazon breached both rules.

    In Mar. 2017, a US Tax Court ruled that Amazon did not breach rules regarding intangible transfers (in the United States) because the Amazon Luxembourg buy-in was appropriate; the Court affirmed that the most relevant share of the value of the intangibles was developed during the cost share agreement and not before (US: TC, 23 Mar. 2017, *Amazon.com, inc. v. Commissioner of Internal Revenue*, no. 31197-12).
70. *See* Herzfeld, *supra* n. 32.

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In the author's opinion, this has already happened because now, as in the past, many (powerful) countries do not want to surrender any part of their fiscal sovereignty. This is the true and historical problem of the ALP. Rather than being a technical problem (which could be addressed), it is a political one.

Anyone who believes that the ALP can be replaced by a simple formula (based on sales, assets and salaries) to allocate a multinational's profit (or loss)[71] must realize that it is nearly impossible to abandon the ALP. Countries that cannot even agree on clearer rules and on mandatory rulings when valuations of intangibles are necessary to apply the ALP will never agree to a specific formula that benefits some over others.

Formulas and mandatory arbitration for the ALP can only come into existence once countries surrender their sovereignty in favour of a superior notion of a state. This occurred with regard to the US federal states (formula) as well as the European Member States (arbitration in respect of income adjustments based on the ALP, as well as the Common Consolidated Corporate Tax Base project). This is unthinkable, however, between, for example, the United States and China.

The ALP is the only functional path for international agreement, although it is still an uphill battle. Consent on the principle is, however, becoming increasingly apparent. It is easy for states to agree on a general and abstract principle like the ALP, which seems fair because it mimics what happens when independent parties negotiate and seems to be an equitable rule for dividing taxes among states. However, after agreement on a general principle is reached, each state involved in the transfer pricing game can interpret such a principle consistent with its own interests when the interests of different states clearly conflict.

The valuation of intangibles is an age old and well-known issue for economists, but it is still problematic, often leading to cases of abuse or of purported abuse and litigation. Governments will continue to claim to be fighting tax-evading multinationals that are illegally shifting profits to tax havens. Firms, conversely, will continue to respond by being fully tax compliant. Harsh litigation and double taxation resulting from a misapplication of the ALP or unilateral taxation by individual countries is foreseeable.[72] The (correct) rule to be applied to a specific transaction of a particular firm will only become evident years after the transaction.

The OECD has the full right to change the principle and to introduce the notion of "control over intangible-related functions" to counter "cash boxes" residing in low-tax countries.[73] As, however, this principle is enforceable in respect of all transactions and regardless of the country involved and prevents abusive, as well as ALP-compliant planning, the author believes that the OECD should clearly affirm that the ALP has changed,[74] in general, from the past.

With regard to value creation, too much importance is given under the new (no longer viable) ALP to the "labour"[75] factor and too little to "capital". Furthermore, too little attention is given to risks borne by capital at the moment the intra-group transaction is established, which means that the ALP is not in compliance with the realities of market economies.[76] Transfer pricing outcomes stemming from the new rules are far from reflecting actual "value creation" in capitalist economies (despite what the OECD asserts).

In the author's opinion, the OECD should rename the principle to more closely reflect its new features, calling it, for example, "profit location in the country where the managers of important intangible-related functions work". The author has proved in this article that the OECD notion of control over intangible related activity clashes with the economics of contracts when applied in a true

71. Some authors support formula allocations that are more simple, direct and effective than the ALP. *See* R. Avi-Yonah & H. Xu, *Evaluating BEPS*, Michigan Public Law Research Paper No. 493 (15 Jan. 2016), available at https://ssrn.com/abstract=2716125.
72. Some authors already came to this conclusion more than 10 years ago. *See* Musselli, *supra* n. 19.
73. This article does not focus on the minimum structure required to avoid being labelled a "cash box without substance" because the assumption is made that the research funder in the example, while it does not control the research activity, is above a "cash box" minimum threshold. *See supra* n. 4 and n. 35.
74. *See* Barnes et al., *supra* n. 4, who state that: "If the text [of the OECD TPG] intends to depart from the arm's length standard by taking the view that this type of risk management does not support an investor's residual return in a controlled group context, it should say so plainly". *See also* Tremblay & Nawaz Nanji, in OECD, *supra* n. 4, at p. 687 et seq., under "A shift away from the arm's length principle to allocation of profits based on Article 7 and the AOA".
75. The Notion of control over intangible-related functions introduced by the OECD seems to revive the Marxian theory of labour value (labour socially necessary to produce a commodity), while market prices also include a part of revenue that goes to reward capital (and sometimes rents). The "transformation" of Marxian values in prices was long debated by Marxian versus Liberal economists. *See*, for example, P.A. Samuelson, *Understanding the Marxian Notion of Exploitation: A Summary of the So-Called Transformation Problem Between Marxian Values and Competitive Prices*, 9 J. of Ec. Literature 2, p. 399 et seq. (1971).
76. *See also* the numerous authors and business parties whose comments are included in OECD, *supra* n. 4. In particular, Barnes et al. note that: "We believe that investment risk should, and does, attract residual profit in the market". KPMG International notes that: "The Discussion Draft seems to assume that the assumption of risk is inseparable from decision making at all levels, and that the ownership of capital/assets has little or no impact upon the allocation of risk. This assumption is simply not consistent with observed arm's length behavior". Moreover, Tremblay & Nawaz Nanji note the following under "Labour vs Capitalists", pp. 691-693:

> The Draft suggests that the mere provision of capital should entitle the provider to little or no return where the provider does not have the wherewithal to manage or exploit the capital on its own. The presumption is that capital providers should receive at most a financing return, while residual returns should be ascribed to the contributions of labour [...] If the service provider functions can be reliably priced, why doesn't the residual go to the capital provider who takes the financial risk and whose appropriate return will likely be much harder to reliably determine? [...] The OECD theory that a rational investor would always invest in the service provider rather than the capital provider is clearly not supported by AL (arm's length) facts such as the case of the investor / fund manager. AL third parties routinely invest in funds or projects managed by independent service providers.

Hafkenscheid, *supra* n. 53, at p. 22 affirms that: "The claim by the OECD that in arm's length situations, the party controlling the risk will demand the risk premium is totally unfounded". *See also* C. Silberztein, *Should we twist the arm of the principle?*, ExpertGuides TRANSFER PRICING (2015).

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bargaining context, as in the case of the specific facts implied in example 17 of the OECD TPG on intangibles.[77]

77. Only conclusions on the specific facts assumed in Example 17, and that make reference to control over intangible functions, can be proved true or false in complying with the ALP in the sense explained by K. Popper, *Conjectures and Refutations: The Growth of Scientific Knowledge* (Routledge & K. Paul 1963).

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