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## Formulaic (or Formulary?!) Apportionment Wearing Value Creation Clothes: Is the Wolf Dressed in Sheep's Clothing?

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### Nothing changed but the change

Despite several changes were introduced to Chapter I and Chapter VI of the 2017 OECD Guidelines on intangibles in accordance with Actions 8-10 BEPS Final Reports to align taxing rights and value creation, those changes were not substantial to permit an application of the ALP that will prevent profit shifting to low-tax jurisdictions. In fact, the general outcome of the modification to the new 2017 OECD TP Guidelines does not match the intentions of the OECD to retain profits as expected. The entitlement to profits from intangibles after BEPS in correspondence with DEMPE functions prompted on a new normative *functional-formula-based* standard that will only contribute to more profit shifting where actually value is created. In fact, the shifting may remain via an orchestrated shifting of development, enhancement, maintenance, protection and exploitation (DEMPE) functions. However, taxation will be aligned with substance and taxation where value is created, provided that those functions add value to the respective intangible. Nevertheless, it remains uncertain how value is created. This uncertainty is functional to the manipulation of the arm's length principle since there is still no parameter to draw a line between what is "acceptable" tax planning and what is not. Value creation alone as a concept to align "taxation where value is created" would not be sufficient with that purpose since we do not really know how value is created. Against all expectations, low-tax jurisdictions will continue to play a significant role in the international tax stream, contrary to what has been expected by high-tax jurisdictions, because there are no defined sound parameters to determine whether an arrangement is commercially rational.

If we want something to change beyond a mere formal change, there is need of a rethinking of the arm's length principle that goes beyond the principle as an allocation of profits standard and value creation as a standard that goes beyond a redefinition of the source.

### Allocation of profits and anti-avoidance: two sides, same coin

This "new" *functional (i.e. DEMPE) -formula-based* standard based on value creation has two functions. First, that of a standard to allocate profits based on the *fractional-functional formula* (objective approach to value creation). And second, that of a *standard of anti-avoidance* since great emphasis is given to substance of a transaction in two but interrelated phases (subjective

approach): i) through the process of accurate delineation of the transaction, i.e. the ALP focuses on pricing the “the real deal” so this preliminary phase assesses the actual conduct of the parties to a transaction without the need to resort to the exceptional case of recharacterization in the form of the substance-over-form rule (anti-avoidance tool) as it was in the 2010 OECD TP Guidelines; and ii) through the *holistic commercial rationality test* which in the 2017 OECD TP Guidelines is a standard to recognise a transaction. The commercial rationality test, despite having the same wording as before the modifications by Actions 8.-10 BEPS, deserves a new interpretation within the *functional-formula-based* standard of value creation. Generally, the commercial rationality test or commercial irrationality test must be interpreted considering that value creation for transfer pricing purposes is more than a redefinition of the source principle as Jonathan Schwarz’s expressed in his blog that indeed source without substance (i.e. DEMPE functions) is no source of income. This leads to foreshadow that the arm’s length principle reinforces its original intent as anti-avoidance standard provided that so much emphasis has been made in the substance of the transaction. Actually, the stress on substance what leads to Schwarz to conclude that source without substance is no source of income, it is in fact a search for the originating cause of the income which is an economic concept different from the “source” which is a legal concept. In this regard it is worth mentioning that, although value creation is ring-fenced for transfer pricing purposes, it does not prevent the potential conflicts that may arise with respect with tax sovereignty for two reasons. First, it tries to define what source and as Wilkie[1] states this approach is consonant with seeing the arm’s length principle directionally as a source rule in an environment where there is no universal source rule, even if that definition is by negative implication, i.e., carving out where it is not reasonable to consider income to have been earned because functions are not performed. Trying to define source by positive implication for transfer pricing purposes is a much harder task to do, i.e. where it is more reasonable to consider income to have been earned is a default from where it is not reasonable to consider it to have been earned, however that is not enough to determine indeed how income has been earned. For that value creation needs to look into the global value chain to provide an objective answer as to where actually value has been created based on business factors (i.e. people, revenue, capital) as an objective approach to align actual conduct of the parties with legal arrangements (i.e. legal substance) so to prevent not genuine profit shifting provided value creation materialize the anti-avoidance function of the ALP.

Yet, even having determined where income has been earned based on business factors, it is still necessary to assess *whether* the allocation of profits made based on the “new” functional (i.e. DEMPE)-formula-based standard could be commercially rational based on sound business parameters through a global value chain analysis and within the comparability nature of the ALP that, like it or not, remains applicable.

The commercial rationality test should allow to prevent distortions in the allocation of income and for that we have to look how the income has been earned because the arm’s length principle should prompt that the allocation of profits is not tainted with tax-avoidance behaviour. However, the arm’s length principle should be interpreted in a way that counteracts structures in which profit shifting is triggered by a questionable behaviour, not where tax has been avoided as a natural outcome of how the allocation of income with respect to the elements of the production process take place. A questionable or unacceptable behaviour occurs when parties said they were doing something in a certain place in their legal arrangements when actually, the something was going somewhere else, or when they were doing something in accordance with their legal arrangement but still that conduct, despite legal substance, is not commercially right based on the location of business functions considering that countries tend to specialize in specific business functions rather specific industries. For that purpose, there is need of understanding how GVCs operate based on

the specialization of business functions in each jurisdiction so it could, from an objective but not absolute approach, determine whether a tax planning structure based on where DEMPE functions and factors are located is commercially rational, for example, if we look at the people in the group structure, one question could be: is the business sustainable with the people located in that jurisdiction? What are these people really doing? Are they really necessary for that function? Could that activity be performed somewhere else? Under the current transfer pricing regime, there is no certainty because there is no framework in which the analysis can be judged. Functional and financial analysis is just describing what happens but does not provide any reference point to do the analysis of value creation. The functional (i.e. DEMPE)-formula-based apportionment does not provide with a more subjective analysis necessary to target a genuine value-generating alignment of profits with activities.

After the BEPS Project, we find ourselves in a sort of limbo in which the ALP as a comparability tool is almost dead and the “new” functional formula-based standard of value creation seems to be the right approach to take the lead as regards transactions to allocate profits in a reasonable, although imperfect manner. At the end of the day if we call it functional (i.e. DEMPE)-formula-based standard or formulary apportionment does not change much the nature of the allocation of income that clearly now goes beyond comparability. Actually, we have been applying this fractional approach already before BEPS, however it was not so evident as it is now because the previous OECD TPG were not as explanatory as they are today (2017 OECD TPG). We agree with Wilkie[2] that DEMPE is an example on how the OECD has adopted formulary apportionment, without so labelling it. Instead they better call it “taxation where value is created”.

## END NOTES

[1] Scott Wilkie, *New Rules of Engagement? Corporate Personality and the Allocation of “International Income” and Taxing Rights*, in Brian J. Arnold Ed., *Tax Treaties After the BEPS Project A Tribute to Jacques Sasseville* (Toronto: Canadian Tax Foundation, 2018), 349-386, and in particular footnote 16 and 14 referring to Hugh J. Ault and David F. Bradford, *Taxing International Income: An Analysis of the U.S System and Its Economic Premises*, in Assaf Razin and Joel Slemrod, Eds., *Taxation in the Global Economy* (Chicago: University of Chicago Press, 1990) 11-46. See also League 1933, para 608, post note 15; and League 1939, para 24, post note 15.

[2] S. Wilkie, *The Way We Were? The Way We Must Be? The “Arm’s Length Principle” Sees Itself (for What It Is) In the “Digital” Mirror*, *forthcoming*

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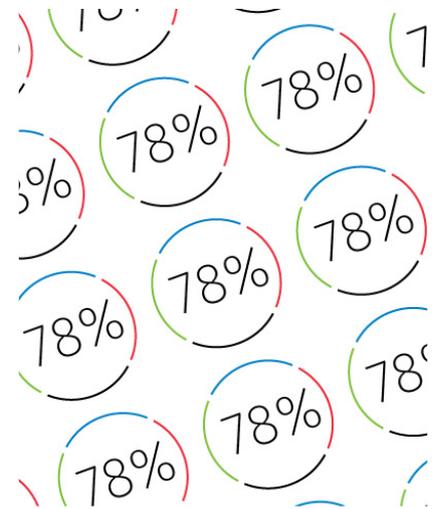
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