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"Transfer Pricing, Integration and Novel Intangibles: A Consensus Approach to the Arm's Length Standard"

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SCHEDULE FOR 2014 NYU TAX POLICY COLLOQUIUM
(All sessions meet Thursday 4:00-5:50 p.m., Vanderbilt-208, NYU Law School)

1. January 21 – Saul Levmore, University of Chicago Law School, "From Helmets to Savings and Inheritance Taxes: Regulatory Intensity, Information Revelation, and Internalities." (Main discussion paper); and "Internality Regulation Through Public Choice." (Background paper).

2. January 28 – Fadi Shaheen, Rutgers-School of Law, Newark, "The GAAP Lock-Out Effect and the Investment Behavior of Multinational Firms."; "Evaluating Investments of Locked-Out Earnings (an Outline).

3. February 4 – Nancy Staudt, University of Southern California, Gould School of Law "The Supercharged IPO."

4. February 11 – Thomas J. Brennan, Northwestern University School of Law, "Smooth Retirement Accounts."

5. February 25 – Chris Sanchirico, University of Pennsylvania Law School. "As American as Apple Inc., International Tax and Ownership Nationality."

6. March 4 – James R. Hines, Jr. and Kyle D. Logue, University of Michigan Law School, "Delegating Tax."

7. March 11 – Stephanie Sikes, Wharton School, Accounting Department, University of Pennsylvania. "Cross-Country Evidence on the Relation between Capital Gains Taxes, Risk, and Expected Return."

8. March 25 – Matthew C. Weinzierl, Harvard Business School, "Revisiting the Classical View of Benefit-based Taxation."

9. April 1 – Andrew Biggs, American Enterprise Institute, "The Risk to State and Local Budgets Posed by Public Employee Pensions."

10. April 8 – Susannah Camic Tahk, University of Wisconsin Law School, "The Tax War on Poverty."

11. April 15 – Nirupama Rao, NYU Wagner School, "The Price of Liquor is Too Damn High: State Facilitated Collusion and the Implications for Taxes."

12. April 22 – Kimberly Clausing, Reed College, Economics Department, "Lessons for International Tax Reform from the U.S. State Experience under Formulary Apportionment."

13. April 29 – David Gamage, Berkeley School of Law, "A Framework for Analyzing the Optimal Choice of Tax Instruments."

14. **May 6 – Mitchell Kane, NYU School of Law, "Transfer Pricing, Integration and Novel Intangibles: A Consensus Approach to the Arm's Length Standard."**

Transfer Pricing, Integration and Novel Intangibles: A Consensus Approach to the Arm's Length Standard

Mitchell A. Kane*

In 2011 the OECD launched an expansive investigation into the question of how arm's length transfer pricing should evolve to deal with the problem of intangibles.[1] Intangibles (which admit of no location, are frequently unique, and almost always difficult to value) have always been a sort of Achilles heel of the arm's length standard.[2] But as value created by multinational firms is increasingly driven by intangibles, there is a widespread perception that we are presently facing not mere difficulty but something more in the nature of a crisis. If arm's length transfer pricing cannot solve the intangibles problem, or at least make serious inroads on it, then one must confront the very real possibility that the arm's length standard is unlikely to have long-term viability.

This initial draft of this paper was prepared and presented as a framing paper for a two day conference held at the Max Planck Institute for Tax Law and Public Finance in July 2012. The purpose of that conference was to bring together academics, practitioners, and OECD representatives for a wide ranging discussion of issues implicated by the OECD's project on intangibles and transfer pricing. Clearly, the foundational question that one must answer in this context is this: What is an "intangible"? Until we have a clear, well-grounded answer to that question it will make little sense to set down a special system of rules and regulations regarding the transfer pricing consequences for the category of "intangibles." As a framing matter, then, this paper focuses on that particular question. Or to be more precise, it focuses on an aspect of

* Gerald L. Wallace Professor of Taxation, NYU School of Law. I would like to thank Wolfgang Schön for his detailed comments on this project and for hosting me at the Max Planck Institute for Tax Law and Public Finance, where I wrote the bulk of the paper. I have received additional very helpful feedback from Steve Shay and Hugh Ault. I further thank the participants in the Transfer Pricing and Intangibles Conference held at the Max Planck Institute for Tax Law and Public Finance in Munich (July 2012), the Northwestern Tax Policy Colloquium, the Harvard Law School Tax Policy Seminar, and the UCLA Tax Policy and Public Finance Colloquium. I would also like to acknowledge the generous financial assistance of the Filomen D'Agostino and Max E. Greenberg Research Fund at the NYU School of Law.

1. For background on that project see Silberztein, C., "Transfer pricing aspects of intangibles: the OECD project", 08/11 TPIJ 2-8 (2011).

2. For a general overview of the arm's length standard, see OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations pp. 31-58 (2010).

that question which is particularly nettlesome. Namely, I deal here with the issue of how arm's length transfer pricing ought to deal with the value generated by the integration of assets within multinational firms -- that is, what one might commonly call synergistic gains (or sometimes losses). To date, the arm's length standard has not countenanced a distinct intangible to take account of this value. Should the method be expanded to include "novel intangibles" (that is, an expanded approach to intangibles as compared to the status quo) to account for this value?

We can begin with a reminder of the severity of the issue regarding integration of assets within multinational firms. In the words of the OECD Transfer Pricing Guidelines (hereafter, "Guidelines"), some critics take the arm's length standard to be "inherently flawed" due to its inability to handle the gains from integration.[3] At the core of that critique is the idea that a method based on respecting the separateness of corporate entities under common control and on allocating profit across such entities by reference to a baseline of uncontrolled, but comparable, situations *cannot* account for the profits from integration, as they derive from the very fact of common control. In the body of the paper below I will take great care to dissect the various aspects of this claim. One of the key messages will be that not all types of integration should be analyzed in the same way when assessing the merits, and optimal shape, of a comparables-based analysis. To motivate the overall inquiry at this introductory stage, however, we can take the basic critique on its terms, which suggests simply that the comparables-based approach at the core of the arm's length standard fails when it comes to integration.

If one were intent to defend the arm's length standard against such a charge, one natural approach would be to search for ways in which one could *refine* the standard. One might be

3. See Guidelines p. 34, Para. 1.10. This basic critique appears many places in the literature. The first extended treatment appears in Langbein, S., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* p. 635 et seq. (1986). For a sample of subsequent discussions of the critique see Avi-Yonah, R., S., "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation", 15 *Virginia Tax Review* (1995) p. 89 et seq.; Vann, R., "Reflections on Business Profits and the Arm's-Length Principle", in: Arnold, B.J., Sasseville,J., and Zolt, E.M. (eds.), *The Taxation of Business Profits under Tax Treaties* (Canadian Tax Foundation, 2002), pp. 139-40; and Auerbach, A.J., Devereux, M.P., and Simpson, H., "Taxing Corporate Income", in: Institute for Fiscal Studies, *Mirrlees Review: Reforming the Tax System for the 21st Century* (2010), pp. 870-71.

tempted to generate ever more copious categories and delineations of categories of intangibles within transfer pricing guidelines or regulations. Specifically, one might consider the introduction of a specific "integration intangible" or "synergies intangible," with the goal of having some specific regulatory mechanism to allocate what could otherwise not be allocated through analysis of comparables. The basic premise I would like to defend in this paper is that the introduction of such novel intangibles is *not* a desirable way of refining or bolstering the arm's length standard. Rather, I will defend the position here that as a general matter one should favor the delineation of fewer intangibles rather than more; should favor intangibles that can be identified by relatively clear conceptions of legal ownership rather than those that cannot; and should not introduce novel intangibles into the analysis in an attempt to capture or reflect specifically gains from integration. The argument will take a number of steps to develop but the basic policy motivation is simple. I will argue that this approach best serves the core aim of transfer pricing analysis to reduce the risk of double taxation, while achieving a reasonable allocation of tax base across countries.[4]

This paper will be organized as follows. In the first part I undertake two basic framing problems, one related to the continuous versus discontinuous nature of arm's length versus formulary methods and the second related to a proposed categorization of intangible value arising from integration of assets. In the second part I describe how the perceived inability of the arm's length standard to handle gains from integration through a comparables analysis could be expected to produce the temptation to introduce novel intangibles into the analysis. In the third part I develop what I refer to as a consensus approach to the arm's length standard. The version of consensus developed here is not the typical one, which suggests that one of the key

4. On the central function of arm's length transfer pricing in reducing the risk of double taxation, see Neighbour, J. and Owens, J., "Transfer Pricing in the New Millennium: Will the Arm's Length Principle Survive?", 10 George Mason Law Review (2001-2002) pp. 952-54. Regarding my focus on "double taxation" as opposed to other (sometimes more fundamental) issues such as overall effective tax rate, see discussion below at page ____. Regarding the focus on double taxation rather than double non-taxation, see the discussion below at page ____.

reasons to embrace the arm's length standard is the existing international consensus regarding its status as the preferred means of income allocation across countries. Rather, the vision of consensus I defend here is that one should read Article 9 of the OECD Model Convention as stating a preferred methodology for reaching a consensus non-overlapping allocation of a *portion* of the profit earned by associated enterprises, namely that portion which could have been earned at arm's length. I then use that interpretation to argue affirmatively against the introduction of novel intangibles.

It must be acknowledged that the topic addressed here is very much a moving target. Shortly before initial presentation of this paper, OECD Working Party Number 6 released an interim discussion draft on the intangibles project. Within the year, the intangibles project was encompassed within the broader project on base erosion and profit shifting, or BEPS.[5] Then, in late July 2013, Working Party 6 released a revised discussion draft. Within this context, it is my hope that this paper will be read as (i) offering a conceptual framework for the issue regarding novel intangibles; (ii) offering an implicit defense of OECD positions that ultimately survive and align with the views stated in this paper; and (iii) offering an implicit critique of OECD positions that ultimately survive and depart from the conclusions reached herein.

Regarding the fundamental issue of whether to recognize a distinct intangible to reflect the gains from integration, the relationship between the conclusions I reach in this paper and the conclusions reflected in the revised OECD discussion draft can be briefly summarized as follows. First, the revised discussion draft is in accord with my basic conclusion that one should not introduce a novel intangible into transfer pricing analysis to reflect group synergies. Second, the revised discussion draft departs from my basic stance insofar as it would reflect gains (and losses) from group synergies as a comparability factor. As should become clear in the course of this paper, reflecting such gains (and losses) through comparability analysis risks many of the

5. For general background see Ault, H., "Some Reflections on the OECD and The Sources of International Tax Principles, 70 Tax Notes Int'l (2013) p. 1195.

same problems as I suggest would arise in the case that the synergistic value is reflected as a distinct novel intangible. Cutting in the other direction, though, the revised discussion draft makes a marked attempt to cabin in the use of group synergies in comparability analysis by drawing a fundamental distinction between cases that involve "concerted group action" and those that do not. Only those circumstances that do involve such action will permit of reference to synergistic effects in comparability analysis. The predictable effect of this limitation would be to reduce the risk of double taxation, which I describe below as a chief detriment of taking account of synergistic effects in transfer pricing analysis. Third, the consensus-based approach I defend in this paper places substantial weight on concepts of legal ownership in transfer pricing analysis. This stance is again in tension with the approach in the revised discussion draft, which tends to place diminished weight on legal ownership. Thus the OECD's preferred method of analysis is to countenance legal ownership only insofar as it accords with the standard transfer pricing functional analysis which must take account of functions performed, assets used and risks assumed. As with the basic issue of how to handle synergistic gains broadly, the basic position defended in the paper is that departures from concepts of legal ownership invite incremental risks of double taxation. Further, although there may also be important issues of double non-taxation at play, I suggest that this problem is best analyzed *not* as an arm's length transfer pricing issue between treaty partners but rather is best analyzed as an issue either between countries that have no tax treaty or as an issue between coordination of tax systems across treaty partners which runs orthogonal to the arm's length standard.

I. Continuities, Discontinuities and Categories

The basic point of this paper is to think about how, and to what extent, arm's length approaches to transfer pricing ought to accommodate critiques of that method that arise from issues relating to asset integration. Specifically, the concrete question on the table is whether one should either broaden the categories of intangibles currently recognized for purposes of arm's length transfer pricing or sharpen existing categories, or perhaps both. In order to undertake this inquiry I believe it necessary to begin with two tasks related to framing.

The first is to clarify the precise relationship between arm's length and formulary methods. What I am particularly interested in here is the way in which these rival approaches can be viewed as falling along a continuum in some -- but not all -- respects. This is important to the way in which we understand how arm's length methods can evolve to respond to critiques regarding asset integration. The critique that the arm's length approach is "inherently flawed" generally arises from proponents of global formulary apportionment, an approach which spares the taxpayer and tax administrator from the search for comparables. If the approaches do in fact lie on a continuum, this suggests that the critique can be met, at least to some extent, through incremental moves along the continuous spectrum of possibilities, even if one stops short of full endorsement of global formulary apportionment. If the methods lie not on a continuum, however, but have instead certain discrete elements, then such an approach of incremental response would not be available. As I discuss below, I think there are both continuous and discrete elements at issue, with profound implications for how the arm's length approach should best deal with the integration problem.

The second framing issue involves the categorization of intangibles. The goal here will be to define categories that take proper account of the relationship between intangibles and the integration of assets within and across distinct corporate entities. As I explain below I will analyze the intangibles problem under a basic four-part categorization. Although the concept of "integration" implicates a number of my categories (three of four, to be precise), the basic point is that from the standpoint of a comparables-based analysis, not all integration is created equal. The categorization is meant to highlight these differences and thus lays crucial groundwork for the ultimate argument against the introduction of novel intangibles into the administration of arm's length transfer pricing.

A. Continuity and Discontinuity

The first task here is to have a clear statement of the relationship between core arm's length approaches and core formulary approaches. Under one view these methods should be viewed as lying upon a continuum rather than as discrete alternatives.[6] To the extent such a continuum exists, the extreme endpoints would not be controversial. The comparable uncontrolled price method would lie on one extreme end and pure global formulary apportionment on the other. Under this sort of continuum analysis, the relevant variable which changes continuously as one progresses across the spectrum is the percentage of total profit that is allocated through a comparables analysis versus the percentage of total profit which is treated as a residual and allocated by a non-comparables based formulary approach.[7] This description has some appeal. It accurately describes the endpoints of the comparable uncontrolled price method (0 residual) and global formulary apportionment (100% residual). Further, one could make an assessment of any particular method and determine the relative amount of profit allocated by residual. Finally, over time the evolution of the arm's length standard has clearly incorporated greater reliance on residuals that are allocated other than by resort to comparables,

6. See, e.g., Avi-Yonah, note 3, p. 89 et seq.

7. I think this is a fair characterization of the position offered by Professor Avi-Yonah in his extended analysis of transfer pricing methods falling along a continuum. At times in his treatment, though, he adopts a somewhat different characterization. Under that alternate characterization there is not a single continuous path from the CUP to global formulary apportionment. Rather, one encounters a discrete jump at some point along the spectrum where we shift from empirical based arm's length methods (that is location of actual comparables) to hypothetical arm's length methods (that is the yielding of results that would have been achieved at arm's length even if there is no actual arm's length reference transaction in existence). Once one has made the discrete jump, however, then the range is supposed to be continuous. This would be evidenced by the fact that even pure global formulary apportionment could satisfy a hypothetical arm's length test. I find the presentation in the text to be sharper analytically, however, as even the profits-based transfer pricing methods generally rely on comparables to some extent.

such that this sort of continuity analysis gives us some way to measure that evolutionary movement.[8]

For the reasons I develop below I think this simple continuity analysis, in spite of certain merits, is importantly incomplete. The reason to introduce it, however, is that it highlights the crucial way in which increasing complications regarding intangibles, especially intangible value from integration, could be expected to play out as an evolutionary matter under arm's length transfer pricing. The embrace of greater reliance on residuals under arm's length transfer pricing has occurred over time not as a conceptual ideal but rather as a concession to the practical reality of the unavailability of required comparables. To this day methods based on comparable uncontrolled price will prevail over other methods, so long as adequate comparables are available.[9] This is to say that within the camp of approaches that consider themselves loyal to the arm's length standard there is a normative preference for the reliance on comparables over residuals. It follows that if one can draft regulations that assist in the location of meaningful comparables this would generally be viewed as a desirable outcome.

Now enter intangibles. Because of their nature as relatively unique assets, intangibles place increased pressure on the identification of comparables. Further, as intangibles increase in complexity and value compared to tangible assets, the amount of residual profit which cannot be readily allocated through straight analysis of comparables can also be expected to increase. How might one try to modify or elaborate upon the regulatory structure regarding intangibles under arm's length transfer pricing to address this state of affairs? The temptation, I believe, is to think that by introducing novel intangibles into the regulatory structure we improve matters either by increasing the likelihood of finding comparables in the first place (thus reducing residuals) or by improving the allocation of residuals by moving the allocation in a direction thought to be more

8. For an explicit discussion of this sort of evolutionary understanding of the transfer pricing continuum see Li, J., "Global Profit Split: An Evolutionary Approach to International Income Allocation", 50 *Canadian Tax Journal* (2002), p. 857 et. seq.
9. See Guidelines at Para 2.7; U.S. Treas. reg. 1.482-3(b)(2)(ii)(A).

consistent with the overall arm's length framework (perhaps because more likely to accord with a hypothetical arm's length test). As already suggested, my goal in this paper is to argue generally against the introduction of novel intangibles in the context of asset integration. The first step in the argument is to demonstrate that the simple comparables versus residuals continuum is an incomplete way of understanding the relationship between different approaches to transfer pricing.

We can begin with the observation that the arm's length standard is best understood as embracing a cluster of concepts.[10] Disaggregating that cluster is crucial because, as we shall see, certain concepts are amenable to a sort of continuity analysis, while others are not. Consider what the Guidelines refer to as the "authoritative" statement of the arm's length standard:

> [Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

This statement may be authoritative but it is not monolithic. It comprises different elements, which we can take to be constitutive of the arm's length standard. I propose to distinguish among four components embedded in this statement: relevance of comparables, ex ante nature of determinations, taxpayer specificity, and relevance of separate entity status.[11] These factors are

10. There is an important strand in the literature that explains the way in which the arm's length standard has taken on different roles over time. Specifically, the original focus was on allocation of profits in the branch context, with the case of allocation across associated enterprises being a mere afterthought. It was a much later development wherein the analysis of the associated enterprise assumed pride of place. See Vann, R., note 3, p. 135 et seq. Although I consider the different ways in which one handles allocation in the branch versus associated enterprise case to be a crucial part of the analysis regarding integration (and discuss it further below), my point in the text here is simply about the various aspects of the arm's length standard as applied to associated enterprises.

11. The Guidelines themselves embrace similar distinctions. For example, the Guidelines take care to explain why the transactional profit split methods endorsed therein are distinct from global formulary apportionment. The grounds for distinction include the fact that global formulary apportion is "predetermined" (i.e., operates on an *ex ante* basis) and applies to "all taxpayers" (i.e., operates on a general rather than specific basis). Guidelines at Para. 1.18.

interconnected but not identical. More crucially, I suggest that some of these concepts are subject to a continuity analysis, while others are not. I discuss these four factors in turn below, concluding that the first three are amenable to a continuity analysis but that the last -- the separate entity approach -- is not.

First, consider the issue of comparables. We have already seen above the way in which the relevance of comparables is susceptible to a continuity analysis in the sense that one can incrementally increase the amount of residual profit that is allocated other than by an analysis of comparables. Current instantiations of the arm's length standard, of course, have already moved some way along the spectrum on this issue. Along this dimension, then, there does appear to be something of an underlying continuity.

Second, consider the ex ante/ex post distinction. Arm's length approaches to transfer pricing are in their purest form ex post methods in the sense that they contemplate that the tax administrator makes an ex post adjustment to a taxpayer's stated prices or booked profits after the fact with the aim of more appropriately reflecting income and/or the division of the tax base.[12] Formulary approaches, by contrast, contemplate, in their purest form, governmental adoption of an applicable formula ex ante. The continuum aspect of the problem suggests that this discrepancy between the two approaches can be eroded through incremental moves towards the center. Indeed, that seems to be precisely the case. Arm's length methods can evolve against a general ex post backdrop to allow greater and greater advanced pricing agreements, ultimately converting the process into much more of an ex ante determination. Alternately, formulary approaches could accommodate ex post adjustments to a stated formula on a case by case basis. Experience has shown the evolution of APAs under arm's length methods. Although experience

12. Note here that I am focussing on the nature of the problem from the government's perspective. There arise a different set of issues both with respect to how the taxpayer sets its own prices in the first instance and whether on examination one should look to information that arises after the original setting of prices (retrospective approach) or only to information available contemporaneously (prospective approach). For a discussion of this issue under the Guidelines see Wittendorf, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, (2010), pp. 388-92.

with ex post adjustments under formulary approaches is less common, observe that the recent proposed council directive for a common consolidated corporate tax base in the EU contemplates precisely this type of mechanism. That is, the proposal contains a safeguard clause that allows departure from the ex ante specified formula in cases where the apportionment under such formula does not "fairly represent" the extent of business activity in a given jurisdiction.[13]

Third, consider the basic issue regarding the question of specificity versus generality. Because arm's length methods are grounded in the idea of governmental *adjustment* to taxpayer's prices, ex ante approaches within this rubric must generally occur at the instigation of the taxpayer rather than the tax administrator. That practice is borne out, of course, in the way that APAs come to pass. Because the taxpayer initiates proceedings the outcomes are more likely to be confined to the circumstances of the particular taxpayer. They are more likely to be specific rather than general because the government in this guise is bound in its articulation of the transfer pricing result by the facts and circumstances presented by the particular taxpayer. By contrast, formulary methods in their pure form are initiated at the governmental level. This opens up much more freedom to articulate principles that prescribe general results across the entire body of taxpayers. Once again, however, as in the case of the basic ex ante/ex post distinction one can see the issue of specificity and generality as lying along a continuum, where initially opposing approaches can come to approximate one another. Starting from the end of the spectrum of pure arm's length approaches the process can become more and more general to the extent that APAs evolve towards greater multilateralism and to the extent they were to become public and have the force of binding precedent.[14] From the direction of pure formulary approaches one could introduce greater specificity by introducing different classes of formula,

13. See proposal for Council Directive Art. 87.

14. For scholarly treatments endorsing multilateral APAs see Avi-Yonah, R.S., "International Taxation of Electronic Commerce", 52 *Tax Law Review* (1997), p. 507 et seq.; and Noren, D., "The U.S. National Interest in International Tax Policy," 54 *Tax Law Review* (2001), pp. 348-49.

for example sector or industry specific formulae. With increasing granularity such formulae would approach a taxpayer-by-taxpayer approach in the extreme. Consider again the experience with the proposed directive for a common consolidated corporate tax base in the European Union. Although allocation under this approach centers around a single generally applicable formula, there are important sector specific exceptions for various industries, such as the financial sector and the oil and gas sector.[15] It is at least conceptually possible for the two methods to approach one another through incremental moves along these key axes.

The final factor included in this constellation of concepts relates to the connection between the arm's length standard and the separate entity principle. As suggested by the canonical definition, respect for separate entity status and the reliance on comparables reflects, in one sense, opposite sides of the same coin. Respecting the separateness of commonly controlled entities is what allows one to pursue a method that compares transactions between such entities to uncontrolled transactions in the first place. Conversely, if one simply ignores the separate entity characteristic then you are thrown back on a formula necessarily. Indeed, from the standpoint of advocates of global formulary apportionment it is the adherence to the separate entity principle which is the chief vice of the arm's length method, as it is precisely that decision which puts one down the very difficult road of searching for comparables in the first place. If one were to stop there, the implication would be that the separate entity approach, like the comparables approach to which it is closely related, also presents a sort of continuous phenomenon along the arm's length-formulary spectrum. The position I defend here, though, is that it is important to acknowledge the way in which the separate entity principle actually functions in a discrete way under the arm's length standard. To see why we must focus on the role of legal form.

15. See proposed Council Directive at Article 86, 98, 100.

Whatever approach to transfer pricing one takes, there is a deep and difficult problem regarding the relevance of legal forms. This basic point is most readily apparent when a firm decides to conduct business in a certain jurisdiction through a subsidiary with distinct legal personality rather than through a branch. Consider a single corporate entity, that is with no corporate subsidiaries but only branches, that conducts business in a multitude of countries alongside an integrated firm that conducts the same set of business operations through a set of separately incorporated subsidiaries. In structuring a tax system one must make an initial decision about whether there will be a general attempt to tax these two organizational forms in a similar fashion or whether one should, instead, establish independent bodies of doctrine that are not linked to one another.

From the standpoint of international allocation of the tax base there are three basic conceptual possibilities that could arise in this respect. These possibilities will be familiar to anybody who has studied the field. My point of emphasis, though, is to seek greater clarity about the costs and benefits of each of the approaches.

The first is what we might call an autonomous approach. Under such an approach the allocation question for branches and subsidiaries could proceed along entirely independent paths; the rules regarding allocation in either case need make no reference to the rules under the other approach. The second two approaches are what we might call derivative approaches. One possibility is that the subsidiary case could be taken as paramount. The results in the branch case would then be derivative upon the results in the associated enterprise case. This is the basic approach under the recently articulated "authorized OECD approach" to attribution of profits to permanent establishments.[16] Under that approach one must, in essence, hypothesize sub-entities (with associated functions, risk, capital, etc.) in order to apply the foundational rules that arise in the associated enterprise case. The other possibility, of course, is just the opposite. The

16. Centre for Tax Policy and Administration, OECD, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, 2010).

branch case could be taken as fundamental and the subsidiary case would be derivative of this. Then we would treat a group of multiple (legal) entities that span jurisdictions as a hypothetical single entity. This is the basic approach of formulary methods such as the proposed common consolidated corporate tax base in the European Union.

I tend to think that most international tax scholars have fairly developed views about which of these three approaches is best, and one can find any number of arguments in favor of each. For my basic point here, which is to highlight the discrete nature of the separate entity approach, we need not resolve these issues. Rather, we need only be attentive to the fact that each of the three approaches invites substantial problems.

Consider a strictly autonomous approach first. The appeal of such an approach is that as a *legal* matter, though perhaps often not as an economic one, the branch and subsidiary enterprise cases look very different. Forcing them into the same legal paradigm is difficult. Pursuing an autonomous approach allows one to avoid those difficulties. The general line between corporations and partnerships in a world of domestic business taxation is an apt comparison. There are powerful reasons to tax business conducted in the two forms in a similar fashion, so as not to distort the non-tax business considerations. Achieving that goal can be difficult (though not impossible) given the substantial differences across legal forms, concerning matters, for example, such as profits distributions. Such difficulties would tend to push one towards an autonomous approach. The chief problem with an autonomous approach, though, is it introduces a discontinuity into the choice of business form, where none may exist as a strictly business or economic matter.[17]

17. For a comprehensive analysis of the merits of continuity in international tax policy generally and in the branch versus subsidiary context specifically see Wolfgang Schön, W., "International Tax Coordination for a Second Best World (Part I)", No. 1-2010 World Tax Journal p. 106 et seq. Note that although it is conceptually possible for an autonomous approach to yield similar outcomes for the single and multiple entity cases, this result is unlikely. It is to be expected that the legal form of the two cases will inform the substantive results, thus driving the outcomes in the two cases apart. At the very least it is extremely difficult to see how an autonomous approach could deliver *greater* similarity of outcome as compared to one of the derivative approaches. That would only seem possible if there were some meta-organizational principle that transcended legal form, which was driving the allocation in the

Such a discontinuity, of course, will recommend the superiority of the derivative approaches. The point I would like to highlight here is that adoption of a derivative approach comes with costs whichever of the approaches one pursues. I believe those costs are more visible where the subsidiary case is taken to be the foundational one. Where the subsidiary case is foundational, one is stuck taking *affirmative* action to hypothesize legal relationships which do not as a legal matter actually exist. This creates numerous complications, which are readily apparent from an examination of the report on the authorized OECD approach to PE attribution under Article 7.[18] Where the branch case is taken as foundational, we force the subsidiary case into the cast of the branch case by *ignoring* the corporate boundaries constitutive of legal personality which taxpayers have chosen to put in place. That may look relatively simple and costless, especially compared to the alternative of hypothesizing non-existent corporate boundaries, but it is not. Of crucial importance here is the fact that domestic tax systems pay substantial heed to and rely upon the notions of legal personality. These are relevant of course, to all of the most fundamental issues for determining and collecting tax liabilities -- as legal personhood is a prerequisite of basic acts such as filing a return, receiving income, paying expenses, and owning property. Moreover, although we are very far from a world in which there is universal consensus across countries regarding the determination of such matters as legal ownership that flow from legal personhood, one of my basic premises is that there is, nonetheless, a very great amount of existing agreement about such matters. This can play out in fairly mundane ways. Discarding such instances of agreement will play out in some quite familiar ways regarding issues of tax base definition. For example under a system that takes the subsidiary case to be foundational, where an actual subsidiary owns and places an asset into use in its locality, there will be little

autonomous case. It is very difficult to imagine what a principle could possible look like. Any approach that I can imagine regarding the base allocation question will have to make some, indeed many, decisions about whether to give credence to legal form or not.

18. The report is rife, for example, with statements suggesting the need for novel approaches to issues such as allocation of assets, risk, and free capital given the absence of any legal contracts or legal separation within the unitary entity. See, e.g., Report on PE Attribution, note 16, at para. 15, 29, 34, 54.

question about the base rules regarding matters such as depreciation schedules because tax depreciation typically aligns with ownership. Where one shifts to a world in which the branch case is foundational then this is no longer a simple matter. The jurisdiction of ownership and location of asset deployment are no longer the same, raising potential issues about base definition.[19] This general phenomenon also has important implications for the specific question under consideration here, which is the way in which the erasure of corporate boundaries negatively impacts existing consensus regarding the way to treat the value that arises from asset integration specifically. I will return to this below, once I have gone through the categorization of different sorts of gains from integration. For now I mean simply to stress the symmetrical aspect of the derivative approaches. If inventing corporate boundaries requires the creation of new information (e.g., where do we place risk within a unitary enterprise that lacks the capacity to contractually allocate risk), discarding corporate boundaries destroys information, much of it valuable. Both approaches have costs.

This basic discussion about continuity and discontinuity provides some valuable lessons. If one thinks of the separate entity aspect of arm's length transfer pricing *merely* as the flipside of a comparables-based analysis, then respect for separate entities will seem to be a continuous phenomenon (because the degree of profit allocated by comparables can be analyzed as a continuous variable) and one of the chief detriments of the arm's length method (because locating comparables is time consuming, expensive, and difficult). Conversely, if one views the relevance of the separate entity principle within the context of whether the system more broadly is going to take the subsidiary case as foundational or the branch case as foundational then two conclusions follow. First, the issue of separate entity status is a discrete choice, rather than a continuous one. Assuming one endorses a derivative approach, it is necessary to make an initial,

19. Consider, for example, the way in which the United States curtails the benefits of accelerated depreciation for assets put in use abroad. For an overview, see Kane, M., "Strategy and Cooperation in National Responses to International Tax Arbitrage", 53 Emory L. J. (2004) pp. 152-154. This issue never arises where the assets are owned by a local subsidiary in the first instance.

discrete decision about whether to respect corporate boundaries (and the manifold legal relationships that come along with them) or not.[20] This decision does not lie on a continuum. Second, respect for separate entity status may be a vice with certain costs but it should also be seen as one of the chief virtues of arm's length approaches, for the way in which it preserves valuable information and existing consensus regarding the status of numerous legal relationships across the business world.

When I come to the analysis below regarding the introduction of novel intangibles, I will attempt to bring these conclusions to bear, as they form an important part of the case against expansion of the class of intangibles recognized under arm's length transfer pricing. Specifically, I suggest that the goal should not be to shrink the residuals through introduction of novel intangibles, as might be the tempting approach under the simple continuity analysis presented above. One should, rather, pay heed to the merits of acknowledging only legally recognized intangibles, given the particular role that legal recognition plays as a constitutive element of the arm's length principle in the first place.

B. Categories of Intangibles and the Gains from Integration

Intangibles present substantial complexities for arm's length approaches to transfer pricing.[21] They are impossible to locate spatially and, yet, somehow are supposedly easy to move. They may be extremely valuable, but appear to be immune to valuation with any precision. It is perhaps no surprise, therefore, that current approaches to transfer pricing fail to give clear definitional guidance regarding the umbrella concept of "intangibles." More specifically, the relationship between the concept of "intangibles" and the value derived from integration of assets is a clouded one.

20. To be clear, this decision need not be system wide for any particular tax system. There may be reasons to take different approaches in different circumstances. But for analysis of any particular corporate subsidiary, the decision must be made whether to respect the corporate boundaries or not.
21. See, e.g., Guidelines at Para. 9.93.

The U.S. regulations are illustrative of this point. These regulations define the class of intangibles by listing exemplary members of the class. For example, the list includes, *inter alia*, the following items: patents, know-how, copyrights, trademarks, contracts, methods, and customer lists.[22] There is a further requirement that the listed assets have substantial value independent of the services of an individual. In order to address non-enumerated items which might count as intangibles, the regulations provide that the class of intangibles also includes "other similar items." This requirement of similarity is satisfied, in turn, where the item "derives its value not from its physical attributes but from its intellectual content or other intangible properties." This presents an immediate interpretive difficulty, however. All of the enumerated items in the list are individually transferrable.[23] But the catchall description of "other similar items" set out above does *not* state any requirement of separate transferability. What is the appropriate treatment, then, of an item which arguably derives its value from intellectual content rather than physical attributes but is not capable of being separately transferred? Of particular interest to the analysis in this paper, what is the status of the value that derives from integration of assets? That value cannot be separately transferred but rather can be transferred only along with underlying assets, the integration of which generates value in the first place. The leading view of this issue in the U.S. is that such an item cannot count as a separate "intangible" under the transfer pricing regulations because transferability is a prerequisite of qualifying as an intangible.[24] That view finds support in the evolutionary history of the relevant regulatory language. Thus the final regulations omitted an earlier requirement in temporary regulations stating a commercially transferrable requirement on the grounds that this was redundant given that the broader

22. See Treas. reg. 1.482-4(b). This is only a partial list which gives a flavor of the definition. The full list contains more than 25 enumerated items.
23. This is not to say that all items are subject to commercial transfer with equivalent ease. Items that are registered property such as patents will be relatively easier to transfer than items such as trade secrets, the transfer of which will involve complex contractual provisions ensuring adequate enforcement mechanisms to preserve secrecy. Even so, the enumerated items are at least potentially capable of individual transfer by contract.
24. For a detailed discussion of this issue see Wittendorf, note 12, pp. 601-10.

regulatory provision is about "transfers" of intangible property to controlled parties.[25] This would suggest that any item under consideration is by definition commercially transferrable. Courts have endorsed this outcome.[26]

Matters are not as clear as this might suggest, however, for a host of reasons. First, observe that the redundancy claim that led to the omission of an explicit commercially transferrable requirement in the final regulations is subject to question. The particular items of value that we are concerned with here -- gains from integration -- may be commercially transferrable. The issue, though, is that they cannot be *separately* or *individually* transferrable. It seems to me that this leaves open the question whether in cases where one could achieve a better assessment of valuation by giving credence to a discrete intangible capturing integration gains whether we should do so. The regulatory language does not rule out the possibility. Second, the IRS has continued to take the position in various circumstances that runs counter to a commercially transferrable requirement.[27] Third, the current administration has repeatedly sought changes to the intangibles definition which would clearly expand the definition of intangibles beyond the class of items which is commercially transferrable.[28] Fourth, even if the regulatory definition of "intangibles" does not extend beyond items that are commercially transferrable, courts have attributed substantial, separate value to items which are best thought of as gains from integration in cases where the relevant transfer among controlled parties is of goods or services, as opposed to the intangibles themselves.[29] Finally, the regulations clearly take

25. See T.D. 8552 , I.R.B. 1994-31.

26. See Merck & Co. v. United States 24 Ct. C. 73 (1991); Perkin-Elmer Corp. v. Commissioner, TCM 1993-414 (1993).

27. See Wittendorf, note 12, p. 599 (citing TAM 200907024).

28. See, e.g., Dept. of the Treasury, General Explanation of the Administration's Fiscal Year 2013 Revenue Proposals, p. 90 (2012).

29. See, e.g., DHL Corp. v. Commissioner, 285 F.3d 1210 (9th Cir. 2002) (attributing $150 M to the taxpayer's delivery network).

separate account of value from integration gains through the explicit considerations of such matters as the relevance of transactional volume under contractual terms analysis.[30]

One approach to answering these questions of definition and classification would be empirical in nature. The issue on the table really is how best to understand value attributable to a firm's operations over and above the standalone value of its assets transferred individually. This is a question of crucial importance to the business world, as it necessarily informs a whole range of everyday decisions. Thus we could observe the business world and see what businesses include in the category of intangible assets and how they, in turn, subdivide that category. One could then take such divisions as a starting point for the discussion of how legal regulation would handle intangibles, with the hope that by matching the legal approach to the way business understands value creation we somehow reach a more accurate result. If there seems to be widespread consensus about the merits in separately recognizing a non-transferrable intangible in the business context, then perhaps transfer pricing regulations should seek to emulate this result. In spite of the value that such a classificatory exercise might hold for business and IP managers, however, my suggestion here will be that this is not the preferred approach for intangibles from the standpoint of legal regulations on transfer pricing.

My reason is simple. A legal instantiation of the arm's length standard must determine how best to take account of the issue of comparables. As is well known gains from integration present large complications for a comparables analysis. One of the central points of this paper, though, is that not all gains from integration are alike in this respect. Specifically, the challenges for a comparables based analysis are different depending on the particular type of integration gain at issue. My approach, then will be to attempt to categorize intangibles in a way that aligns with the particular issues that arise under a comparables analysis. An empirical focus on business delineations of intangibles would, I fear, serve only to obscure these issues because they do not

30. See Treas. reg. 1.482-1(d)(3)(ii).

align with the relevant point of concern. They may help one understand how better to explain overall firm value but this may well shed no light on issues of comparability.

I propose, then, to introduce a four part taxonomy of "potential intangibles" as follows: (i) individually transferrable intangibles; (ii) unilateral integration intangibles; (iii) bilateral integration intangibles; and (iv) common control intangibles. (The reference to "potential" reflects the simple fact that I do not mean to prejudge at this stage whether a given category should, or should not, be recognized as a distinct category for transfer pricing purposes.) The first category is the simplest and requires little explanation. This category covers any intangible that can be transferred in isolation to an unrelated entity. Simple examples might be a patent or a copyright. These are the basic items that are explicitly listed in current versions of the Guidelines and the U.S. Treasury regulations. To my mind these sorts of intangibles should be viewed as the atoms of the system and will be crucial to everything that follows, where I will refer to them simply as "category one intangibles."

The other three categories are terminologically abstruse, subtle, and bleed into one another in complex ways. As a first cut then, I think the best way to introduce what I have in mind with this categorization is through a simple example. Let's begin with a sample corporation, *A Corp*, which holds, among other property, two valuable intangible assets: a customer data base and a proprietary computer algorithm which is tailored to work with the particular information in the database to produce a ranking of sales leads. Each of these assets fits in my first category. As a legal matter they could be transferred individually to unrelated entities. Further, for illustration let's suppose that each asset is worth $\$x$ if transferred in isolation. It may well be the case, however, that if the assets are transferred together, they are worth more than the simple sum of their individual values. For example, it may be possible to use the customer database through simple human inspection, even though the algorithm produces better results. It may be possible to use the algorithm on other customer databases but perhaps not as effectively (or without costly modification) given that the original programmers designed the algorithm with specific informational inputs in mind. Again for illustration, let's suppose that in conjunction the database and algorithm are worth $3*x*. The $*x* of additional value, over and above the value of the intangibles in isolation, is what I have in mind with my second category of "unilateral integration intangibles." This is extra value, that is, which exists because of the integration of assets within a corporate entity. Those assets may be category 1 individually transferrable intangible assets, or they could be otherwise transferrable tangible assets. I refer to this as "unilateral" because the relevant value derives entirely from the integration of assets currently inside a single corporate entity. *A* Corp can be assumed to hold many assets that relate to one another in similar ways, producing further value from this type of unilateral integration intangible.

This type of intangible is, of course, closely related to what people typically have in mind through the delineation of residual intangibles such as goodwill. Here, I want to make two further points that potentially distinguish the present analysis from prior treatments. First, the category of unilateral integration intangibles is both broader and narrower than historical conceptions of "goodwill." It is broader in the sense that it is meant to be a single inclusive category that covers *all* residual value that comes from intra-entity integration of assets. It is narrower in the sense that value that has historically been attached to something like goodwill need not derive from the unilateral integration intangible. It may, rather, derive from something akin to the "bilateral integration intangible," as discussed below. Second, I mean to highlight the explicit relationship between the category one intangibles and the unilateral integration intangible. For a static snapshot of any entity, my idea is that the unilateral integration intangible can be analyzed as a single residual category. That residual *can* be subdivided, of course, but *only* through the alienation of individually transferrable assets. So in the example above, a portion of the unilateral integration intangible could be alienated by transferring the customer list and algorithm together.

We can now elaborate upon our simple example to demonstrate the distinctions with the other intangibles in my categorization. Suppose now that in addition to *A Corp* holding a customer database with independent value of $\$x$, unrelated *B Corp* also holds a (non-overlapping) customer database with independent value of $\$x$. Further *A Corp*'s list is now transferred to *B Corp* by contract. It is, of course, possible that the two lists in aggregation have value of $\$2x$. It is also possible, though, that together they are worth something more than this, say $\$4x$ (perhaps because the marginal prospect of attracting or retaining a customer on the lists increases as a function of market share). The extra $\$2x$ of value here is the value captured by my category of the "bilateral integration intangible." At first blush this intangible looks a lot like the unilateral integration intangible. It is value generated by integrating assets within a single entity. But it is crucially different in the sense that the residual value held by *A Corp* (value over and above value from selling individually transferrable assets separately) is not merely a function of its own assets but rather also a function of the assets held by *other* entities. If *A Corp* were to transfer its customer list into an empty corporate box, that is, it would still have value of only $\$x$ (if only because we assume a market of firms like *A Corp* which would be willing to purchase the intangible for $\$x$, even in the absence of any bilateral integration effects). Under this description we consider *A Corp* to hold an intangible insofar as it has the capacity to realize value in a way over and above the individual value of its individually transferrable assets (and over and above the value realized from contracting away all of those assets to a corporate shell holding only cash). It is vital, however, to note that *A Corp* does not in this example hold a bilateral integration intangible worth $\$2x$. All that can be said is that there is a joint premium of $\$2x$ to be had from bringing the customer databases together by contract. The division of that $\$2x$ across

A Corp and *B Corp* raises standard problems about the division of surplus, to which I will return later in the paper.

With a final modification to this example it is possible to demonstrate the distinct concept of my fourth category, the common control intangible. Suppose that instead of transferring *A Corp*'s customer database to *B Corp* by contract, one imagines the two databases coming together because the two corporations come under common control or ownership. One possibility is that the two customer databases, taken together, are again worth \$4*x*. It is also possible, however, that they are worth something more than this, say \$5*x*. This additional \$*x* of value compared to the case of transfer by contract might reflect the fact that the licensee firm may have to undertake enforcement efforts to prevent the licensor firm from cheating on the contract (e.g., from continuing to use the customer database in violation of contractual terms). The further \$*x* of value achieved through common control derives from what I call the "common control intangible."

I will use this four part categorization in the remainder of the paper to motivate my basic underlying claim that a transfer pricing analysis under the arm's length standard should only take account of the category 1 intangibles -- those capable of being separately transferred. The reason to subdivide the rest of the intangible universe into three categories, rather than just a single category of "everything that is not transferrable" is that my categorization is intended to assist with capturing and separating out different strands of the critiques of the arm's length standard, as well as some of the predictable responses to such critiques. Moreover, as the simple example above was meant to show I believe the categories hold together as distinct conceptual constructs, at least at their core. This ought not to obscure, however, a different point, which is that the categories also bleed into one another in deeply problematic ways.

First, observe that as a conceptual matter the unilateral and bilateral integration intangibles are getting at very different sorts of value creation in the sense that the former arises in virtue of ownership (of multiple assets) and the latter arises in virtue of contract (between unrelated owners of assets). Thus the bilateral integration intangible will implicate problems of bargain over surplus while the unilateral integration intangible will not. Even so, as a practical matter it may be very difficult to separate unilateral and bilateral integration intangibles for the simple reason that parties may contract and create bilateral integration gains at the very same time they are transferring multiple assets which embody value from prior unilateral integration. In the simple example above I constructed numbers that separated out these components. But this is highly unlikely as a practical matter, where, for example, we might see *A Corp* transferring its customer database and algorithm to *B Corp* for some fixed price. This simultaneously implicates both unilateral integration gain (i.e., the continued pairing of *A Corp*'s database plus algorithm) and bilateral integration gain (i.e., the pairing of *A Corp*'s database and *B Corp*'s database). More generally, whenever a transfer involves multiple assets one faces the prospect that consideration for the transfer reflects value both from what I am calling the unilateral and bilateral integration intangibles. Thus unilateral and bilateral integration intangibles are necessarily muddled together, notwithstanding the fact that they represent different phenomena which play out differently, as we shall see, under comparables analysis and under standard critiques of the arm's length standard.

Second, note that the common control intangible and the unilateral integration intangible are conceptually more closely aligned in the sense that the value in each case derives from ownership of multiple assets. The difference is that one represents gains from ownership and integration within a corporate entity and the other represents gains from ownership and integration across separate corporate entities brought under common control. Thus the $\$x$ of value attributed to the common control intangible in my example (the premium explicable, for example, by savings from not having to police contractual abuse) could just as well have been realized in the case where the two customer databases were owned by a single corporate entity from the outset. Given the overlap here, it would be nice if we could ignore the distinction between unilateral integration intangibles and common control intangibles. But of course because the defining feature of the arm's length standard is a separate entity approach, that is precisely the distinction we should not ignore. This is fraught with its own blurring issues, though, because note that in a case with common control of *A Corp* and *B Corp* we can expect simultaneous existence of the *A Corp* unilateral integration intangible, the *B Corp* unilateral integration intangible, and the common control intangible. Value generated by these intangibles may look like the same sort of thing but under the arm's length standard we should think about them distinctly.

These types of blurring support my overall thesis rather than detract from it. In ways that will become clear below, the drawing of these initial distinctions helps us to get some purchase on the actual strength of various critiques of the arm's length standard, as well as the nature of an appropriate response. Specifically, the categorization I introduce here has been chosen with an eye to highlighting and distinguishing three distinct types of critiques that one might raise against the way in which the arm's length standard struggles to handle problems raised by intangible value from integration in the context of a comparables based analysis.

One type of critique is that there are cases where comparables literally cannot exist as a conceptual matter. The common control intangible aligns with this first type of critique, regarding conceptual impossibility. A second type of critique is that there are cases where comparables exist but that they produce such a range of results so as to make the administration of the arm's length standard unsound. The bilateral integration intangible is meant to clarify analysis of the critique regarding unmanageable ranges of comparables. The third type of critique is that there are cases where comparables could exist as a conceptual matter but do not exist, to a meaningful extent, as a matter of fact. The unilateral integration intangible will assist our understanding of the empirically grounded critique regarding the factual unavailability of good comparables. I consider these three types of critiques and the relevance to the introduction of novel intangibles now in Part II.

II. The (Tempting) Case for Novel Intangibles

A. Common Control Intangibles and the "Inherent Flaw" of the Arm's Length Standard

The Guidelines observe that "[t]he arm's length principle is viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities across integrated businesses."[31] Stated in this way, the supposed "inherent flaw" does not overlap neatly with my categorization of intangibles, as a number of my categories would seem to have something to do with economies of scale and gains from integration. Indeed, part of my goal in slicing up the intangibles pie the way I have done is in an attempt to urge sharper thinking about the precise implications flowing from the critiques of the arm's length standard regarding integration. Thus each of my three categories (other than category one) of intangibles is meant to demonstrate a distinct sort of issue regarding integration.

The "inherent flaw" seems present, perhaps most present, with respect to my category of common control intangibles. As applied to this category, the critique that is supposed to point out the "inherent flaw" suggests that not only does something like a common control intangible exist but that in fact the value from such intangibles is the very reason that we see integrated multinational firms under common control in the first place. This value is uniquely tied to the fact of common control across separate corporate entities. It cannot, by definition, be realized by separate entities contracting at arm's length. This allows one to state succinctly the core of the critique, as it relates to common control intangibles: there are literally no arm's length comparables as a conceptual matter.[32] Note that the search for comparables here could

31. Guidelines at Para. 1.10.

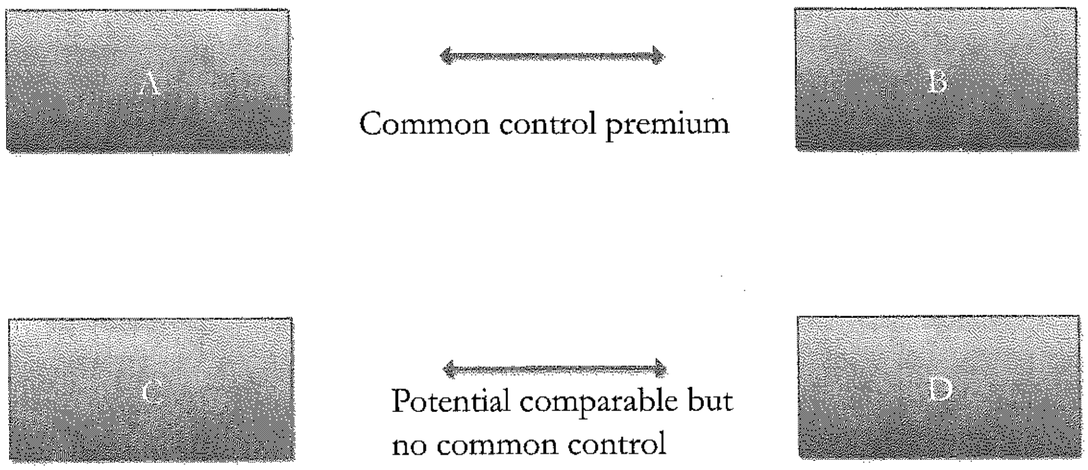
32. For development of this critique see the range of sources in note 3.

encompass any items generally recognized under existing arm's length methodologies (category one intangible assets, tangible assets, or services).

I think it is important to emphasize the conceptual nature of this point, as it has become clouded with other complexities that plague real world application of comparables analysis. In other words, suggestions of an "inherent flaw" in the sense of the literal impossibility of locating comparables have become blurred with other issues. First, observe that the claim I wish to isolate here is *not* that comparables are difficult to find as an empirical matter because the taxpayer holds some sort of unique firm-specific intangibles. The taxpayer *does* hold something that could be thought of as a unique firm-specific intangible here, but that is not the crux of the issue confounding a comparables based analysis. For example, a patent (i.e., a category one intangible) might also be a unique firm specific intangible that makes for difficult comparables analysis. But it is not conceptually impossible that one might find another patent that is sufficiently similar to form the basis of the comparables analysis. Not so with the common control intangible. Second, the claim I wish to isolate is *not* that the comparables are difficult to find because would-be candidates for comparables analysis, particularly unintegrated entities operating at arm's length, have been competed out of the market (precisely because of their competitive disadvantages). Under that sort of problem it is again conceptually possible that if one is not in competitive equilibrium a suitable comparables analysis could be undertaken. The issue with the common control intangible, as I have defined it, does not fall into either of these categories. (These other critiques are themselves important but they raise different issues and align with other sorts of intangibles in my categorization.) No amount of searching, whether in competitive equilibrium or not, could ever hope to identify a comparable for the value associated with the common control intangible.

We can see this by considering the following diagram.

Diagram 1: The Common Control Intangible



In this example *A Corp* and *B Corp* are under common control, which is to say the integration of the assets of the respective entities yields a certain premium. In my taxonomy that premium is captured by the common control intangible. Supposing one could identify a seemingly good comparable transaction between *Corp C* and *Corp D*, which are not under common control, then by definition, there is no common control premium in that case, rendering the comparable incomplete. The only two ways *Corp C* and *Corp D* could replicate the common control premium would be either to come under common control themselves (in which case there is no longer a reliable arm's length benchmark) or to bring the assets of *Corp C* and *Corp D* into a single entity (in which case there is no longer even a non-arm's length price to observe as a potential comparable).

The literal impossibility of locating comparables to reflect the common control premium might suggest that one should move towards an explicit endorsement of a hypothetical approach to arm's length transfer pricing rather than an empirical approach.[33] Even in the absence of comparables, that is, one could phrase the hypothetical question about how parties *would* have priced matters, and allocated profit, if they were to confront the situation faced by the commonly controlled entities. Indeed, this seems to have been the explicit stance of the U.S. Treasury when it undertook a thorough review of U.S. transfer pricing regulations in the 1980's. In addressing the critique that seems to point in the direction of the "inherent flaw" the U.S. Treasury suggested that the proper interpretation of the arm's length standard is that the arrangements between controlled parties must be compared to the "arrangements that would be made between unrelated parties if they could choose to have the costs of related parties."[34]

Such a shift to a hypothetical arm's length standard, however, seems not to be responsive to the basic critique which it is meant to address. The particular statement quoted above appeared in response to an influential argument first made by Professor Langbein.[35] Langbein introduced into the literature the idea that in this context the arm's length standard presents a "continuum price problem." The idea is simply that where affiliates of a multinational enterprise realize a synergistic gain from integration, in virtue of the common control, such gain belongs to neither affiliate in isolation. The gain is a return to organization and it is theoretically defensible to make *any* allocation of the surplus. Whatever the allocation, that is, each affiliate ends up better off than it could do operating strictly at arm's length.

It is quite helpful to cast this argument in terms of the phenomenon of bilateral monopoly. Although Professor Langbein does not refer explicitly to bilateral monopoly, the suggestion of a theoretical indeterminacy of price as between two parties who must contract to

33. For further discussion of the role of empirical versus hypothetical arm's length approaches see Wittendorf, J., note 12, pp. 18-19.
34. I.R.S. Notice 88-123, "A Study of Intercompany Pricing under Section 482 of the Code", 1988-2 C.B. pp. 483-84.
35. Langbein, S., note 3, pp. 654-55.

realize a type of rent is a hallmark of bilateral monopoly.[36] Further, I think a proper understanding of the relationship between bilateral monopoly and transfer pricing is crucial here. The complication is that the phenomenon is relevant in a number of different ways, which are not suitably differentiated in the current literature. Indeed, it is one of the chief features of the basic categorization that I have introduced above that it is meant to tease out some of these different implications.

Consider, then, that there seem to be three distinct ways in which the phenomenon of bilateral monopoly could shed light on our understanding of transfer pricing analysis. First, we confront the issue highlighted above. Where we have commonly controlled entities that realize a common control premium, this functions like a bilateral monopoly -- but *only* by analogy. The classic bilateral monopoly problem, of course, exists between parties operating at arm's length. Common control and vertical integration can thus be one way of solving a bilateral monopoly problem. Even so, the analogy is instructive for the following reason. If the best we can do with respect to the common control premium is to engage in a hypothetical arm's length analysis (as suggested, for example, by the U.S. Treasury analysis noted above), then it seems appropriate that we should consider the fact that at arm's length the parties would be in a bilateral monopoly situation. The allocation of the premium would then in fact be theoretically indeterminate. Second, we have a very different sort of issue, which is that when undertaking a comparables based analysis, the reference transactions that we examine may themselves reflect an *actual* bilateral monopoly. This is the sort of situation I mean to separate out by introducing a distinct category for what I term the "bilateral integration intangible." I come back to this below. Third, there is a completely different issue implicated by the relationship between tax transfer pricing and business transfer pricing. This is well beyond what I can cover in this paper but I mention it briefly here just for the avoidance of confusion. Sometimes vertical integration will fail to solve a

36. For a casting of the basic argument relating to synergy gains in terms of bilateral monopoly see Schön, W., note 17, pp. 247-48.

bilateral monopoly problem. Specifically, if there is divisional autonomy then vertically integrated entities will seek to maximize own-entity profit rather than group profit. From a business perspective internal transfer pricing could be used to try to solve this problem. The great complexity is that in any case where there is one set of transfer pricing books the vertically integrated firm will have to determine both how its transfer pricing approach affects pre-tax joint production and how it affects the after tax situation. Although this sort of issue has undergone substantial analysis in the managerial literature it has taken on much less importance, as far as I can tell, in the tax policy literature on the preferred content of transfer pricing rules.[37] I consider that this should be part of the tax policy research agenda on transfer pricing but I will put the issue to the side here.[38]

Returning to the core point at issue in this subsection, the question is how the fact of theoretical indeterminacy regarding the common control premium could be expected to affect the evolution of transfer pricing rules. My intent here is merely to point out the way in which this critique might well be expected to lead to the introduction of a novel intangible by defenders of the arm's length standard. In other words, if existing comparables analysis cannot account for a crucial element driving firm profit, then a tempting response is to introduce something like a "synergies intangible" to capture such value, along with a method for allocating the gains from

37. See, e.g., Hiemann, M., and Reichelstein, S., "Transfer Pricing in Multinational Corporations: An Integrated Management- and Tax Perspective", in *Fundamentals of International Transfer Pricing in Law and Economics* ed. Schön, W., and Konrad, K. (2011) p. 3 et seq.

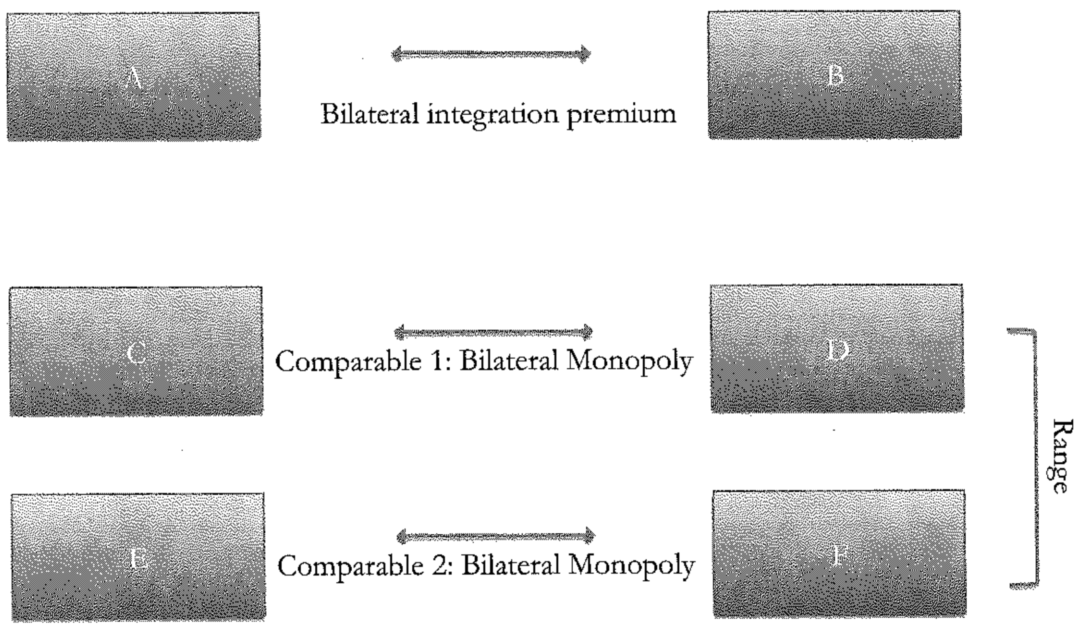
38. A quick supposition on why the tax policy literature tends not to confront this issue. The basic normative frame of arm's length transfer pricing is that the tax rules ought to give parity of treatment to integrated firms and non-integrated firms. This is thought to preserve incentives for efficient organization. Thus the basic efficiency question given consideration is about choice of organizational form (integrated or not) rather than efficiency implications of transfer prices, holding organizational form constant. For example, suppose vertical integration is optimal in a certain case as an approach to dealing with a double marginalization problem. But then suppose further a vertically integrated firm sacrifices some of those benefits because of the complex interaction of divisional autonomy and the incentives for optimal pre-tax and post-tax transfer pricing. Under the basic normative frame of the current arm's length transfer pricing rules, there would be no failing here insofar as the tax rules have not led to the choice of the sub-optimal organizational form. The fact that the tax transfer pricing rules could possibly be drafted to yield further efficiency gains (by taking greater account of the interaction with optimal pre-tax transfer prices under divisional autonomy) seems not really to be part of the current normative discourse.

such intangible in a way that is at least not inconsistent with general arm's length methodologies. I will return the merits of such an approach below.

B. Bilateral Integration Intangibles

The problem under the arm's length standard with bilateral integration intangibles is importantly different from the case of common control intangibles. The difference is subtle, however, and risks being obscured by overly general statements about the relationship between difficult to value intangibles, gains from integration and failures of the arm's length standard. The clearest way to understand the problem with bilateral integration intangibles is that there is not the same conceptual bar to the existence of comparables with such intangibles, as in the case of common control intangibles. The basic problem here could be stated as one in which comparables can exist but in a way such that what the comparables reveal regarding arm's length pricing is indeterminate and falls upon a range. The best way to see this is by drawing upon the distinctions drawn above regarding bilateral monopoly. Consider the following diagram.

Diagram 2: The Bilateral Integration Intangible



In this example *A Corp* and *B Corp* are again under common control. Unlike the case examined above, though, this example isolates the gain from integration of assets across *A Corp* and *B Corp* is of a type which *could* be accomplished by contract at arm's length.[39] In the diagram above transactions between *Corp C* and *Corp D* as well as transactions between *Corp E* and *Corp F* are potential comparables. Each of these comparables, however, represents an instance of

39. There is a complicated empirical question about the extent to which this type of integration will occur within a multinational enterprise. One might suppose that if there are gains to be had through contract, then parties will choose to realize such gains through contract rather than through ownership. However, there is reason to suppose that gains from this type of integration do occur inside multinationals. Decisions about organizational form are likely to have something of a discrete character, such that firms do not necessarily implement a decision regarding the relative merits of hierarchy versus markets continuously with respect to every single input or output. One might encounter cases, then, where the net gains from organizational firm are positive but in which there are particular instances of intra-firm trade that are best analyzed as representing simple gains from contractual integration rather than from common ownership. For example, suppose a parent company produces similar outputs as a foreign manufacturing subsidiary. Assume further that the foreign subsidiary contracts with a local unrelated party for inputs, creating a bilateral integration gain. If the subsidiary then on-sells some of those inputs to the parent for its own manufacturing processes, my suggestion is that this should be understood as a gain from integration within the firm that could have been realized by contract with third parties.

bilateral monopoly.[40] Again, this could happen with respect to tangible assets or category one intangible assets. If one refers back to my example from above, the idea would be that the customer databases come together in a way to generate some premium over and above the value of the databases in isolation. Thus with respect to that premium it is as if one firm is monopoly seller of list and the other firm is a monopsony buyer of the list. Because of this phenomenon, one can expect to see a range of bargaining results, *even* at arm's length. Moreover, that range will reflect overall bargaining power in ways that are almost certainly outside the purview of transactional arm's length transfer pricing. The likely consequence is a range of defensible transfer prices, even where suitable comparables have been found.

How might one respond to this critique? If one perceives the range as a problem then one potential solution would again be the introduction of novel intangibles. Recall that in theory the return to the taxpayers' category one intangibles (or tangibles) in this sort of context may look divisible. There is the part that represents the value of the intangible if it were exploited in ways that brought no integration gains. This for example would be the case of licensing the customer database to the broader market where there is no integration gain from coming together with another database. Then there is the part that seems to represent the gain from integration. If the latter part is indeterminate under a comparables analysis because of bilateral monopoly issues between parties operating at arm's length, then perhaps one tempting solution would be to treat the category one intangible as representing only the value that earns the ordinary (non-integrative) gain. And then one could introduce a further intangible into the analysis, which presumably would take the form of some type of residual intangible at the entity level. That is, something like goodwill or an analogous concept. Once such an intangible is

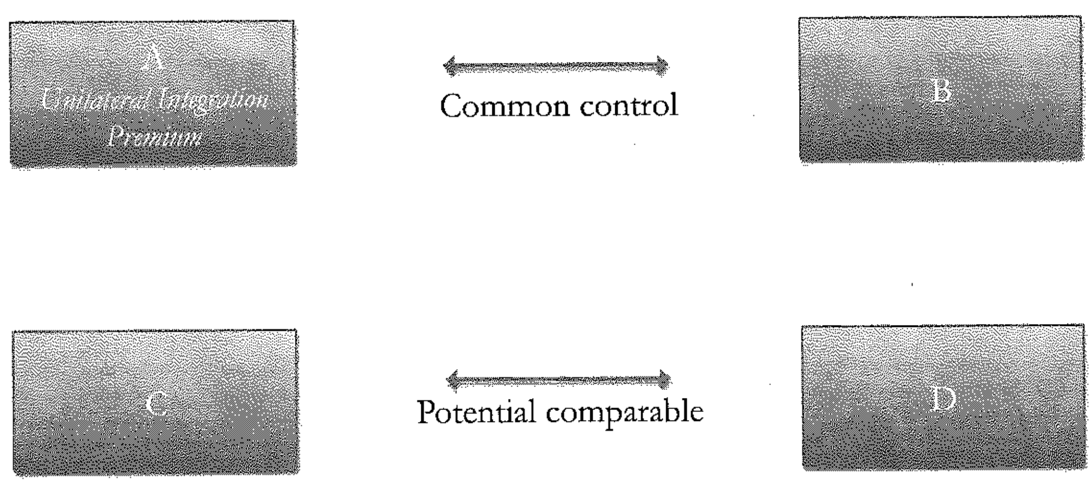
40. In practice there will be a tension between identification of good comparables and the degree to which bilateral monopoly is in existence. For, example, if the comparable reflects the purchase and sale of a good that is identical or very similar to a good transferred under common control then there may well be some competition between the controlled and uncontrolled parties, diminishing the bilateral monopoly aspect of the parties operating at arm's length. Even so, there may well be cases where the comparables are derived in cases where there is not product market competition between the controlled and uncontrolled parties.

introduced one would also need some specified regulatory method of allocation because, by definition, it would not be possible to find comparables for the intangible *directly*.[41]

C. Unilateral Integration Intangibles

In this final section I take up the issue of unilateral integration intangibles. The challenge with respect to this category is not that identification of comparables is conceptually impossible, as with common control intangibles, or that identifiable comparables will produce a range reflecting bilateral monopoly price indeterminacies, as with bilateral integration intangibles. Rather, the issue here is that the identification of good comparables for category one intangibles (as well as tangible assets) is greatly complicated as a practical matter by the gains derived from unilateral integration of such assets. Let's consider a simple diagram once again.

Diagram 3: The Unilateral Integration Intangible



41. Another sort of approach would be to try to reflect issues of bargaining power within the comparables analysis. If one observes an arm's length range arising because of differential bargaining power in bilateral monopoly situations then one might be tempted to hypothesize relative bargaining power of the commonly controlled parties as a way to select the most defensible results within the range. I do not follow this line of analysis in this paper, though, as it seems deeply problematic to hypothesize relative bargaining power across units of a unified firm. Even with some divisional autonomy, such an approach would seem highly manipulable as taxpayers could attempt to alter the seeming bargaining power of respective units with, for example, strategic capital contributions.

The point here is that assets held by *A Corp*, for example, have additional value because of integration. Under an arm's length analysis *A Corp* should be compensated for this. To return to the example above suppose that *A Corp* uses its customer database and proprietary algorithm to generate a ranked list of sales leads. If this list is transferred to *B Corp*, which is under common control, then an appropriate arm's length transfer price should compensate *A Corp* for the gains from integration. It is not, as with the common control intangible, literally impossible to find a comparable for this. The goal would have to be to find comparable transactions, however, that arise out of entities with similar sorts of internal integration. In practice this becomes very difficult to do.

This sort of difficulty could once again lead to a tempting call for introducing novel intangibles into the analysis. The temptation derives from the same basic points we saw above regarding the common control intangible and the bilateral integration intangible. Indeed, the types of intangibles have a crucial overlap. The value deriving from the unilateral integration intangible *may* be the same type of value as drives the value underlying the common control intangible (that is, value from integration that can only be realized through common control or ownership and not by contract). Or, the value deriving from the unilateral integration intangible *may* be the same type of value as drives the value underlying the bilateral integration intangible (that is, value from integration that could be realized through contract even absent common control). Thus in the face of evidence that value or profit is being generated within the firm in a way that is explicable in terms of some factor that is not adequately captured by the existing taxonomy and classification of intangibles, a seemingly good remedy would be to introduce further intangibles into the analysis to match the categorization that best explains the profit generation of the firm.

Observe, though, that although there is overlap in the type of value generated, the categories remain conceptually distinct from the standpoint of a comparables analysis. As we saw above, with the common control intangible the location of comparables is a literal impossibility, and with the bilateral integration intangible the issue is the generation of ranges of defensible transfer prices. The unilateral integration intangible is different from both. It is literally possible to find comparables (to the extent that unrelated parties have also chosen to realize gains from common ownership *within* an entity rather than across entities). Likewise, one does not encounter the same issues with bilateral monopoly and transfer pricing ranges as with bilateral integration intangibles. This is because the suitable comparable, to the extent it exists, will manifest integration *within* an entity and thus the monopoly gains have already been "unilateralized." In essence the problems with the first two categories have been remedied precisely because the analyzed party has achieved integration (which could have been achieved either by common control or by contract) within a single entity. The flipside of this, however, is that the identification of relevant comparables becomes more difficult as a *practical* matter precisely because a fully appropriate comparable would have to involve a party operating at arm's length that was enjoying similar within-entity gains from integration.

Because the core problem here, then, is the practical location of good comparables, the tempting strategy might be to attempt to define novel intangibles that at least capture some common value across firms that otherwise manifest differential degrees of internal integration. Consider, for example, two pharmaceutical companies each earning royalties from a commonly controlled subsidiary in the same foreign jurisdiction. The way in which the patents of these companies relate to the integration of assets within each entity may render what would seem to be otherwise a good comparables analysis regarding the patents in isolation as a failed analysis that does not appropriately address the gains from such integration. One approach would be to find firms operating at arm's length that would be expected to earn similar profits based on integration. But locating good comparables for the patents in isolation may well be hard enough; adding on the burden of comparable asset transactions arising in cases at arm's length with similar within-entity integration gains renders the search for comparables very difficult indeed. The alternate approach, then, might be to search for additional commonalities across the firms and identify such value as being derived from a novel intangible not currently recognized in transfer pricing analysis. For example, what if part of the value derived by these companies by licensing intellectual property into the jurisdiction of the subsidiaries was based in part on something like the market features of the jurisdiction? This is a feature that would seem to have much greater commonality than the other features generating profit. This might suggest the promising avenue of breaking apart what might have been thought of as the basic patent into two intangibles, one representing the patent and the other representing the market features. If the second intangible is more amenable to comparables based analysis then this would seem to respond to the basic criticism described above. Moreover, this is just illustrative. Perhaps there are other ways that the intangibles could be subdivided, in a search for *common* creators of profit. In theory this would suggest that the more and more finely granulated you make the intangibles categorization and analysis the more likely you are to identify common intangibles that can be subject to a comparables analysis.

D. Questioning the Critiques

In the above sections I have discussed three ways in which challenges or critiques of the arm's length standard regarding issues of value from integration could well lead to the call for novel intangibles in transfer pricing analysis. In Part III below I will generally offer an argument intended to reject such introduction on the grounds of what I refer to as a consensus-based interpretation of the arm's length standard. The basic import of that discussion is to show how the introduction of such novel intangibles could be expected to be affirmatively harmful. Before turning to that discussion, however, I would like to make a few observations regarding the merits of the above critiques on their own terms. The first set of comments relates to empirical considerations and the second relates to issues of arbitrariness, both in transfer pricing narrowly and in allocations of international tax base broadly.

1. Empirical Considerations.

The above discussion has served to show that issues of integration pose some substantial problems, both conceptual and practical, for the application of the arm's length standard. I do not question that these problems are real or that they may well lead to calls for the recognition of novel intangibles. Even so, what I would like to do here is suggest that the empirical magnitude of these issues regarding integration is essentially an unsettled matter. That is, one must not lose sight of the fact that a lot of complexity and difficulty with comparables analysis under the arm's length standard arises because of the simple location of suitable comparables (either category one intangibles, tangible assets, or services). These are *not* issues about integration and do not present the sorts of problems discussed above or lead to the similar implications regarding introduction of novel intangibles.

Consider the common control intangible, first. As I have suggested this captures the value that is most readily identifiable with the supposed "inherent flaw" of the arm's length standard -- that comparables are literally unavailable as a conceptual matter. Stated in this way, the value represented by the common control intangible might seem to be the gravest problem of all. But how big is this problem in fact relative to other complications with a comparables-based analysis? The basic question, which I think is completely unanswered in the literature, is simply this: How much of a firm's overall value from intangibles comes from something that is specifically linked to the common control intangible? I fear that in critiques of the arm's length standard one sometimes begins with a statement of the critique that is supposed to point out the "inherent flaw" but then this blends seamlessly into a general discussion of problematic intangibles. But there are different issues at play here and I think one requires in the first instance an empirical assessment of relative magnitudes.

As an example, consider the relationship between the common control intangible and category one intangibles. To put some real world import on this basic observation one need only consider the case of some current high value companies that are driven in large part by intangibles. Consider, for example, the cases of a company like Google. To be sure, the company stands to realize value from a common control intangible, the specific value gained from separate corporate entities within the organization being commonly controlled rather than operating at contract. But of course it is also the case that a large amount of the value underlying the company derives from elements such as patents, trademarks, algorithms, and proprietary databases -- all items which can be thought of as category one intangibles. Again, this is not to say that valuation of these items is easy. We have here highly unique and valuable intangibles. That makes it difficult to find parties trading in such intangibles (or the products that one can produce with them at arm's length). But the difficulty in locating comparables is a different kind of problem than the conceptual critique which claims that an arm's length comparable literally could not exist in any state of the world because the value is driven by integration.

Consider further that to the extent one views the "inherent flaw" as a bigger problem than the issues that arise with respect to bilateral or unilateral integration intangibles, one has a further unanswered empirical issue about the relative magnitude of the values attributable to these different sorts of gains from integration. Again, this seems to be an open question in the literature.

Regarding the empirical import of the problems created by bilateral integration intangibles (and the defensible ranges they could be expected to generate under bilateral monopoly analyses), we have the same sort of unanswered issue as with the common control intangibles. To be sure, very broad ranges of transfer prices are a common feature of transfer pricing analysis. But how much of this is generated by bilateral integration intangibles? Of course, ranges can also be generated by the inability to locate category one intangibles that are good comparables in the first place, quite aside from any issues of integration. As always this is a genuine, difficult problem for arm's length transfer pricing but it would not, in the ways discussed above, lead to a natural or obvious call for novel intangibles.

Finally, one also faces questions about empirical magnitude with respect to unilateral integration intangibles. The basic idea there is that different degrees of integration within entities will make it difficult to locate comparables that truly reflect the gains from such integration. But even though firms employed for comparables analysis may not have the same type or degree of integration as a firm for which one is engaging a transfer pricing analysis, it is to be expected that firms that play a role as providing comparables will themselves be complex, integrated entities, generating their own set of substantial returns from integration. This is far from perfect but again calls into question the degree of the problem here. How much of the inaccuracy of comparables based analysis, that is, truly derives from integration issues and how much derives simply from the difficulty in locating suitable comparables for assets which are unique and hard to value, even in isolation?

Pulling these various points together one might highlight four particular empirical issues, of which I think there is no, or only minimal, analysis in the literature. First, numerous articles remind us that multinationals are not like contracting parties and exist precisely because they can realize a profit from organizational form. But empirically how large is this profit compared to the hypothetical profits of unrelated entities contracting at arm's length?[42] The fact that multinationals are pervasive does not tell us much, or anything, in this regard as even a marginal advantage would tend to prefer the multinational organizational form. Second, how much of the economic rent that can be earned because of integration through the multinational form is competed away in equilibrium?[43] Third, when multinationals earn rents from integration in

42. One recent paper that attempts this inquiry is Creal, D., Robinson, L., Rogers, J., Zechman, S., "The Multinational Advantage," (2012) available at http://ssrn.com/abstract=1933777.

43. This issue of economic rent dissipation was raised in the U.S. Treasury White Paper on transfer pricing. See I.R. Notice 88-123, note 34, p. 484.

equilibrium, how much of this rent is strictly due to the multinational form and how much is due to rent that could have been earned through sophisticated contractual mechanisms (particularly long-term contract) at arm's length? Fourth, for multinational firms what is the empirical relationship between what I have called the unilateral integration intangible versus the common control intangible?

Obviously I have no answers regarding the relevant empirical magnitudes. Nor do I mean to suggest that if one were magically to discover that the magnitudes were relatively small that we do not face profound complications and problems under the current transfer pricing system, especially regarding intangibles. The point here is simply a cautionary one. Although the argument from the "inherent flaw" seems to be very powerful on conceptual grounds, I do not see that it has to date been proven that this particular issue is what actually causes the range of woes under current transfer pricing analysis. Many of those woes could well exist under a comparables based analysis simply in virtue of difficult to value, relatively unique category one intangibles, quite aside from any issues or value related to integration. To take heed of the cautionary note, then, would suggest that the need for introducing novel intangibles to buttress the arm's length standard against critiques grounded in gains from integration has not yet been made.

2. Arbitrariness.

Aside from issues of empirical magnitude, one should also consider the ways in which arbitrariness relates to the potential introduction of novel intangibles to bolster the arm's length standard. Consider that the critiques that are connected to the common control intangible and the bilateral integration intangible are at their core about the way in which the arm's length standard will have to allocate the profit associated with these intangibles in an arbitrary fashion. For the value associated with the common control intangible there are no comparables to reference at all. For the bilateral integration intangible we have comparables but possibly ones that produce an unworkable range. In each of these cases, then, an analysis of comparables underdetermines the allocation of profits across commonly controlled entities. This might suggest that without some modification to existing approaches such profits will have to be allocated in an arbitrary fashion. The point I would like to make here is a simple one, and one that has been made before.[44] The arbitrariness point begins with the observation that allocation of profit to separate entities under the arm's length standard is necessarily arbitrary. This in turn means that the allocation of taxable profit to the respective *jurisdictions* is likewise arbitrary. This point, however, cannot be a sufficient basis for the introduction of novel intangibles to redress the arbitrariness issue. The problem is that *any* approach which seeks to allocate the profits from cross-country integration of assets will be arbitrary, at least to some extent. Thus the introduction of a novel intangible can displace the allocation that would have arisen without the intangible but this will simply be to displace one arbitrary allocation for another. (So too, incidentally, for a fuller rejection of arm's length methods for formulary methods, which likewise will have to adopt arbitrary ways of allocating the relevant profits.) This does not mean that we are powerless to make comparative evaluations about which approach is the best way to allocate such profits. Indeed, it is one of the core tasks of the discussion in Part III below to undertake just that type of inquiry. But one cannot adjudicate the issue on the grounds of one approach being more or less arbitrary than another.

III. A Consensus Approach to the Arm's Length Standard

In this part I would like to develop what I will refer to as a consensus approach to the arm's length standard. There are two aspects to this, one interpretive and one practical. Regarding interpretation, the basic claim is that one should *not* read Article 9 of the OECD Model Convention as setting forth an allocational rule which is meant to divide the *full* profits of

44. See, e.g., Röder, E., "Proposal for an Enhanced CCTB as Alternative to a CCCTB with Formulary Apportionment", Max Planck Institute for Tax Law and Public Finance Working Paper 2012-01 p. 9 (2012).

commonly controlled taxpayers across contracting states.[45] Rather, the interpretation offered here suggests that one should read Article 9 merely as attempting to reach a consensus across contracting states regarding a non-overlapping allocation of a *portion* of profits (namely, those profits which could have been earned at arm's length). That portion of profits will represent something less than the full profits to the extent that there is indeed some premium from operating under common control rather than at arm's length. Regarding practicality, the question is simply how best to implement such a vision of Article 9.

I am intent to emphasize here that the argument I develop below relates to the application of the arm's length standard in the treaty context and is addressed to the particular problem of the avoidance of double taxation. My treatment should thus be clearly separated from two other contexts which, although both important and related in certain ways, present quite distinct issues which call for a different way of approaching the relevance of the arm's length standard.

The first such context involves the application of an arm's length standard under domestic law in a non-treaty context. The issue there is much more likely to be that of double *non*-taxation than that of double taxation. Thus in an all too familiar paradigm a home country entity might transfer valuable intangibles to a low- or zero-tax country (with respect to which there is no treaty) for a below arm's length price. Here, bolstering arm's length transfer pricing will be one obvious, albeit complicated in application, way of preserving the home country tax base and ensuring that associated profits bear tax somewhere. Matters are much complicated, and confused, by the fact that countries (the U.S. being a notable example) may apply the very

45. In a formal sense Article 9 does not affect an allocation across contracting states at all because it contemplates adjustments across enterprises, rather than an allocation of the profits of a single enterprise, as for example under Article 7. As a matter of substance, though, Article 9 does achieve an allocation across states. *See* Schön, W., "International Tax Coordination for a Second Best World (Part III)", No. 3-2010 World Tax Journal p. 230 note 11 (2010). Likewise the implication of the consensus view is that Article 9 achieves a *de facto* allocation across contracting states -- but only with respect to a portion of the profits of the commonly controlled enterprises. For a further discussion of the relationship between this view and the position of Professor Schön, see note 54.

same legal concept -- that is, an "arm's length standard" -- in both the treaty context and the non-treaty context. This ought not to obscure the fact that the legal concept is serving a completely different doctrinal function in the two cases. In the treaty context the arm's length standard operates as a constraint on *states* in the way they make adjustments to stated profits of taxpayers, where such adjustments have adverse effect on the base of the treaty partner. In the domestic context (such as in the U.S.) the standard should more properly be seen as operating as a constraint on taxpayers rather than on the state. This simple distinction will be reflected in litigated cases. In the treaty context the taxpayer will be asserting substantive rights under a treaty, thus applying arm's length principles affirmatively. In domestic non-treaty cases it is the government that will affirmatively assert the arm's length principle. This basic distinction offers a hint that it will be useful to analyze the cases separately.

That hint crystallizes once one takes account of the way that the range of potential solutions, and the way in which the arm's length standard fits into that range, looks very different in the domestic non-treaty case. In particular, the domestic non-treaty case, and the problem of double non-taxation that it implicates, should best be analyzed in a side-by-side comparison of the relative merits of applying transfer pricing adjustments versus controlled foreign corporation legislation as an optimal response.[46] Crucially, the relationship between transfer pricing rules and CFC rules will look very different in the treaty context (dealing centrally with double taxation) and the domestic non-treaty context (dealing centrally with double non-taxation). Where the issue involves application of a treaty, it is unlikely that CFC rules will have much affect one way or the other on the prevalence of double taxation. This is because a home country that seeks to include the income of a CFC with residence in the treaty partner, should generally be bound to afford double tax relief in the same manner that would have applied for an actual dividend paid by the CFC to its parent company. Of course the application of CFC rules will still present

46. For an attempt at such an analysis see Kane, M., "Milking versus Parking: Transfer Pricing and CFC Rules under the Internal Revenue Code," [forthcoming Tax Law Review].

important issues because of the potential for raising the effective rate of tax on unrepatriated CFC profits. But this is distinct from the double taxation problem implicated where treaty partners each claim primary rights to tax a certain amount of profit in light of conflicting views on application of the transfer pricing rules. By contrast, in the non-treaty context the application of CFC rules should play a central role in the analysis of any concern with double non-taxation.

The second such context involves the issue of double *non*-taxation as between treaty partners. Although treaties have generally been understood to be centrally concerned with the problem of double taxation, there has been a recent call to arms on the double non-taxation problem, as evidenced by the OECD's project on base erosion and profit shifting (BEPS).[47] I do not mean to downplay the importance of these issues.[48] Nor do I mean to discount the possibility that to the extent one wishes to attack the double non-taxation problem as between treaty partners that the existing bilateral treaty framework may well play an important role. But I would like to suggest that bolstering the arm's length standard is not likely to play a meaningful role in a suitable response to this problem. This is because the double non-taxation problem as between treaty partners is far more likely to involve issues of base mismatch (that is, the base arbitrage problem) or of inadequate information, as opposed to mere tax rate differentials (which tend to be relatively less pronounced between treaty partners and to be generally tolerated as an acceptable exercise of state sovereignty). Thus the problem is *not* fundamentally one of unjustifiable inter-company pricing. Price adjustments will inevitably miss the mark. To take a simple example, suppose a cross-border payment escapes all tax because viewed as deductible interest in the payor's jurisdiction but as an exempt dividend in the payee's. Clearly, adjusting the absolute amount of the payment, as under a transfer pricing adjustment, will not reach this problem.

47. For a summary see Ault, note 5.
48. To the contrary, I have written at length on the very question. See Kane, note 19.

With these two important contexts distinguished and set to the side, we can now proceed to a discussion of the role of consensus in applying the arm's length standard in the treaty context and with a focus on the central problem of avoidance of double taxation.

A. Description of the Consensus Approach

The idea of consensus already plays a crucial role in our understanding of the justification for adherence to an arm's length standard in international taxation. For example, the Guidelines note that "[a] move away from the arm's length principle would . . . threaten the international consensus, thereby substantially increasing the risk of double taxation."[49] The particular consensus referred to in this statement appears to be about consensus regarding adoption of the standard, as well as its subsequent interpretation and administration. Thus the Guidelines go on to say that "[e]xperience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations."

This type of consensus is surely important and may well justify, by itself, adherence to the arm's length standard over global formulary apportionment as an alternative for the foreseeable future. The argument, though, is one from path dependency. It is consistent with the suggestion that if we had gone down a different path at the beginning, leading to a different consensus regarding how to handle these questions, then that alternative would itself now be justifiable based on the grounds of consensus.

What I would like to do here is develop a more robust conception of consensus and its relationship to the arm's length standard (that is one *not* grounded in considerations of path dependency). As noted above, there is an interpretive aspect to this as well as a practical one. I begin, then, with the interpretive relevance of consensus. Because of the way in which the arm's length standard operates, and the way in which it relies on comparables specifically, it is

49. Guidelines para. 1.15.

very tempting to cast the entire arm's length transfer pricing project as one in which we are trying to set prices for intercompany transactions in some way which mirrors an economic reality that exists in market transactions, absent common control. That is precisely the characterization that motivates the idea that the method is inherently flawed. A philosopher might analogize this to a correspondence theory of truth. It is as if the market with parties operating at arm's length is supposed to offer some undistorted view onto how the world actually is as a matter of fact and what we are trying to do is make the controlled case correspond to this. Critics then say this is conceptually bankrupt because you are trying to make two fundamentally different things correspond to one another. Although this characterization has gained much traction in the literature I think it is essentially a misdescription as an *interpretive* matter of what the arm's length standard is actually doing in the context of the OECD Model Convention (at least as currently interpreted by the Guidelines). Under the best reading of what the arm's length standard is actually doing, it has nothing to do with such a correspondence to some independent economic reality. It is helpful here to go back to first principles and be clear about the way in which the arm's length standard works in two related, but distinct, ways in the context of the Guidelines.

First, it is the fact that commonly controlled entities are not bound by market constraints that justifies tax administrations in making adjustments to taxpayer's reported profits *in the first instance*. Within the context of the Guidelines this should be understood as permitting a departure from otherwise agreed allocations of the tax base. Consider two corporate entities, each of which has all of its assets, activities, and employees located in Country A and Country B respectively. Under treaty norms Country A may not tax the Country B entity on its business profits as it has no Country A permanent establishment, and vice versa. If the firms are operating at arm's length then we see no particular problems with allocation of the tax base. That problem is essentially "solved" through the PE concept and Articles 5 and 7 under current treaty approaches. (That is not to say the PE standard is necessarily the optimal standard but it is a consensus solution around which many countries have cohered.) If these two companies are under common control, however, this threatens to eviscerate the agreed norms regarding allocation of the base. Suppose Country A maintains a lower tax rate by a very small amount, say 1/2 a percentage point. The commonly controlled entities would have incentives to shift 100% of the Country B company profit into the Country A entity. Because there are no permanent establishments, Country B would be powerless under the treaty to reach this profit if it lacked the ability to make adjustments to the stated profits of the taxpayer. Thus it is the mere potential of commonly controlled firms to price in ways that depart from the allocations that would result at arm's length that justifies the capacity to make adjustments, notwithstanding the fact that this is in some tension with the PE concept. The Guidelines bear this point out. They state, "When transfer pricing does not reflect market forces and the arm's length principle, the tax liabilities of the associated enterprises and the tax revenues of the host countries could be distorted. Therefore OECD member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any such distortions . . . ."[50] At this point the arm's length principle is certainly not functioning like a correspondence theory of truth. It reflects only the fact, which I think nobody would dispute, that with companies under common control one must permit at least *some* governmental adjustments to reported profits if the agreed treaty allocations of tax base under a residence principle are going to have any meaning.[51]

Now let's take up the second function of the arm's length standard in the Guidelines. Here we have not an original justification for adjustments but a *limitation* on adjustments. The simple numerical example above makes plain the necessity of limitations. If there were *no* limiting principle then Country A in the above example could simply adjust the profits so that all

50. Guidelines para. 1.3

51. This is obvious, at least, as long as we are trying to make commonly controlled cases and other cases somewhat continuous. I think there is a very strong case for this based on continuity arguments. See Schön, note 17. There is no need for such an adjustment under global formulary approaches, as such approaches are not interested in profit at the company level for purposes of allocating the base. These are also, however, radically discontinuous approaches.

of the profits were restated to belong to its resident country firm. Indeed, Country B would have the incentive to make the reciprocal adjustment. The result would be 100% overlapping double taxation on a seeming residence basis and the whole structure of the treaty approach to eliminating double taxation would fall apart. To prevent this the Guidelines rely on the arm's length standard once again. Thus they state, "OECD member countries consider that an *appropriate* adjustment is achieved by establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in comparable transactions under comparable circumstances."[52] This language more readily invites the interpretation that what the arm's length standard is doing functionally is telling us that each entity gets taxed on what it would have earned at arm's length. That looks like a correspondence approach.

But I think that is neither the only nor the best interpretation of what this language means specifically and what the role of the arm's length standard is in the Guidelines generally. Considered within the context of what it is actually doing -- working as a *limitation* on adjustments to stated profits -- I think a better reading of the standard is that it provides a *methodological* approach by which countries can seek to make adjustments in a way that (i) reaches a mutually acceptable non-overlapping allocation of the tax base and (ii) approaches, but does not replicate, the result that would follow in the agreed case, where parties are not operating under common control. This interpretation does not require correspondence. It does not require assuming that the commonly controlled case can be forced into the shape of the unrelated case. I see the unrelated case, rather, as working as a constraint in the limit.

Exposition here may be assisted by the introduction of a simple diagram.

Diagram 4

52. Guidelines para. 1.3 (emphasis added).

a *b* *c* *d*

This diagram is meant to capture the joint profits of the two corporations discussed in my example from earlier in the paper, *A Corp* and *B Corp*, which are under common control, and which have substantially all of their activities in countries, *A* and *B*, respectively. For simplicity assume that neither entity has a PE in the other country. Suppose that the profit that *A Corp* could earn if it were independent and operating only at arm's length is represented by the segment *ab* in the above diagram and the analogous profit that could be earned by *B Corp* is represented by the segment *cd*. The value represented by *bc* is the premium from common control. The practical import of the consensus approach offered here, which is about one of constraints on adjustments, rather than about the setting of underlying residence basis taxing authority is as follows. If the commonly controlled entities state prices in a way that falls somewhere in the interval *ab*, then *Country A* has the power to make an adjustment, but subject to constraint, that is, only up to the point where *A Corp* has taxable profits up to point *b*, reflecting what the entity would have earned at arm's length. Conversely, if the stated profits are in the increment *cd*, then *Country B* has the power to make an adjustment to stated profits, but only back to point *c*, reflecting what *B Corp* profits would have been at arm's length. If the stated profits effect a division represented in the interval *bc*, then neither jurisdiction should have the power to make an adjustment. Such prices, in other words, reflect arm's length prices.

We can contrast this by hypothesizing a counterfactual treaty norm which did in fact use the arm's length standard to establish substantive limits of the residence basis taxing power. One can imagine, that is, the possibility that a treaty standard stipulated that each country could tax on a residence basis only up to the point of what the resident firm would earn had it been operating at arm's length. In the absence of permanent establishments this would suggest that the substantive treaty standard would leave the premium from integration *untaxed*, as neither country would have the power under the treaty to reach the common control premium. In terms of the diagram above *Country A* would have the power to tax its resident firm only up to an amount represented by *ab* and *Country B* would have the power to tax its resident firm only up to an amount represented by *cd*. It is crucial to remind ourselves that this is *not* the way in which the arm's length standard functions in the treaty context. (Moreover, this is *not* because of the operation of savings clauses trumping substantive limits established by the arm's length standard.) After all if commonly controlled enterprises report 100% of their profits (split in whatever portion across treaty partners) and the respective tax administrations make *no* adjustments, it surely would not be open to the taxpayer to claim a refund under Article 9 on the grounds that one of the jurisdictions had exceeded its residence basis taxing authority. Conversely, under my counterfactual treaty norm this is precisely the type of claim that would be open (or, alternately, the firms would be free to report less than 100% of their profits from dealing with third parties in the first instance). It is true that if the taxpayer were permitted to report profits inconsistently across jurisdictions, then the arm's length standard would work as a *de facto* limitation on residence taxing authority. In that case the taxpayer could report *ab* to Country A and *cd* to Country B, leaving *bc* untaxed. However, I take this prospect of inconsistent reporting to be independently rejected by the Guidelines.[53]

To state clearly a point which is probably now obvious, under this interpretation the taxpayer has discretion to set prices in a way that allocates the profit represented by *bc* to whichever jurisdiction it chooses and this would be consistent with the arm's length standard. Some would balk at this, raising the specter of the inherent flaw once again. The segment *bc*, we would be told, is the whole game -- the whole reason for the existence of multinational enterprises in the first place -- and to concede this to taxpayer discretion is to give up on everything we might be trying to accomplish with an arm's length standard for associated

53. See Langbein, note 3, p. 664.

enterprises in the first place. But the mere fact there is discretion ought not to condemn the approach defended here. First, note that prominent treatments in the literature have argued that this element of profit *should* be discretionary and subject to allocation through a mechanism of tax competition.[54] Second, one has the issue of empirical magnitude, which I already discussed above. Even if the common control premium is the very reason for the existence of the multinational enterprise in the first place, this tells us nothing about the relative magnitude of *bc* to the overall profit *ad*. Even so, I suspect many readers will still be left with the abiding sense that explicitly granting taxpayers discretion in this way over what is widely perceived to be a crucial element of value creation for multinational enterprises is surely to risk and invite great amounts of taxpayer abuse. This leads us directly to the practical aspect of the consensus approach argument I am developing here. How should one best achieve consensus?

It helps here to keep in mind the very difficult nature of the problem on the table. The quantity represented by *bc* is an economic rent with no well-defined geographic location. The task at hand is to write a rule that allocates this segment of profit across jurisdictions in a mutually acceptable, non-overlapping way. What are the available options? Broadly, there would seem to be two routes. One could go the route of full global formulary apportionment. On the assumptions of mutual acceptance of base definition and allocation formula, one would get a mutually agreed allocation of the entire profit *ad*, and thus *a fortiori* the segment represented by

54. See, e.g., Schön, note 45, pp. 231-233. Professor Schön's argument consists of two aspects. First, the allocation of economic rents across *entities* should be achieved according to the contractual allocations of the parties (subject to some constraints relating, for example, to symmetry of upside and downside risk). Second, the allocation of taxing rights, including the rights to tax rents, across *countries*, should be determined based on the location of prior investment in countries. That prior investment is supposed to have created the relevant economic rents. In this way the rent is allocated according to standard tax competitive pressures that apply generally to the tax effects on the location of productive assets. The flipside of this is that there is ultimately taxpayer discretion about where to allocate the rent. The argument in the text endorses the first aspect of this claim but not the second. I mean only to claim that it is a defensible interpretation of the arm's length standard under the Guidelines that the taxpayer has the discretion to allocate the value from the common control premium without suffering the risk of adjustment to stated profits. I am less convinced by the second part of the argument for reasons that flow from the general analysis in this paper. Specifically, the economic rents from integration across a multinational firm comprise not just value from what I label the common control intangible but also the unilateral and bilateral integration intangibles. As discussed below I think the value from this sort of integration demands a different type of analysis than the value from the common control intangible.

the common control premium. Or, one could attempt to discern the route within the bounds of the arm's length standard that is most likely to lead to consensus.

Regarding a shift to global formulary apportionment, one confronts the heroic nature of the required assumptions, as many others have pointed out. Those assumptions are about achieving *new* consensus (about base and formula). But I would also like to stress here that such a move seems to squander much *prior* consensus.

"What prior consensus?" would be a natural question to lodge here. As international tax lawyers we are trained at every step to see discord rather than consensus. We approach our entire topic of inquiry, that is, against a backdrop of overlapping, but largely disparate, tax systems. The challenge is to force that jumble into something more coherent, either through multi-party arrangements such as double tax conventions or through unilateral contractions of the tax base that concede revenue in order to avoid the ills of double taxation. One of my major premises in this paper, though, is that for all of this seeming discord one should not overlook the valuable overlap in various national tax systems, including the legal treatment of various private law and contractual arrangements that inevitably feed into the tax base. Moreover, the further premise is that one should seek to leverage that existing consensus to the maximum extent possible. In international matters consensus is difficult and expensive to broker. If one can design institutions and regimes that make good use of the natural points of intersection of the legal systems of various jurisdictions then it would be foolhardy not to do so.

The particular species of consensus I have in mind here then relates to the ways in which countries define and determine corporate ownership of assets as a legal matter. My claim is a simple one: there is a massive amount of overlap in the way in which countries across the world approach this question. That consensus, moreover, is the raw material and not a byproduct of the overall approach to the problem of tax base allocation and avoidance of double taxation. To be clear, my claim of widespread and important consensus is not meant to suggest something like universal overlap. We don't come anywhere close to that. There are at least three important areas of discord on this question. First, jurisdictions will take different views of what counts as a separate corporate entity. Such diverging assessments will lead to different views on the identity of the legal owner of property. A jurisdiction that sees a corporation will find legal ownership at the entity level. A jurisdiction that sees a pass-through entity will find legal ownership at the level of the owners of that entity. Second, jurisdictions will take different views on matters of substance versus form. Thus a formalistic jurisdiction may identify legal ownership with the locus of legal title in a sale-leaseback arrangement. A more substance oriented jurisdiction may find legal ownership lies not with the holder of legal title but rather with the seller-lessor. As should be clear from the text I use "legal ownership" to reflect the idea of ownership for tax purposes, which may or may not align with formalities such as legal title. Third jurisdictions will take different views on how do divide the categories of property in the first instance. This too can lead to divergent determinations of ownership. And yet, a great deal of consensus remains. I am reluctant to put the word "marginal" on the three sources of potential conflict in ownership determinations above. This could well elicit the charge that any analysis of possibilities of double taxation that bracket the issues of hybrid entities and conflicting ownership determinations under national law is to take a head in the sand approach, ignoring some of the most important tools in the tax planner's repertoire. But this again is the perspective of the practitioner or administrator that views the world through the eyes of existing discord that makes for interesting problems of planning and complex issues of administration. Observers from that realm care about the margin, and possibly only about the margin. My point is a different one. If we think about system design broadly, taking up questions such as arm's length versus global formulary apportionment as an overall decision (and not just from the path dependent perspective) then it is crucial we not get distracted by the marginal considerations. It may even be better to ignore them altogether. Thus if we ask a question such as, "How do the various tax administrations of the world view the question of the ownership of inventory in Alabama, with legal title held by a subsidiary of the Toyota Motor Corporation?" I posit that there is a very widespread consensus across many systems in the world on this question of ownership. And so too for many, many other assets across the world. This type of consensus is valuable information that ought not to be ignored.

Consider, though, the ways in which the arm's length standard and global formulary apportionment differ on this particular question. We get most traction here by focusing on what I take to be the truly discrete difference between these approaches, developed in detail above -- namely, the issue regarding separate entity versus unitary entity status. Under an arm's length separate entity approach one takes account of and respects this valuable pre-existing consensus in the first instance. (And for all of the other agreed assets as well). Global formulary apportionment, by contrast, by beginning the entire inquiry by converting legally distinct entities into a fictive unitary one essentially *discards* the wide range of consensus over these many assets. I take this distinction to be a signal advantage, in a comparative sense, of the arm's length standard over global formulary apportionment.

Considering the role of consensus regarding legal ownership of category one intangibles also informs the internal structuring of the arm's length standard. One of the basic points of this paper is that it might be tempting to solve the integration problem by introducing a novel intangible that is meant to capture the value of *bc*, along with a specified means of allocating this value across jurisdictions. But part of the motivation for introducing my taxonomy of different integration intangibles is to make plain that it is an exceedingly difficult regulatory task to isolate the value *bc*. As I discuss further below, approaching this issue with the introduction of a novel intangible invites novel avenues of overlapping tax base and the attendant risk of double taxation.

I turn in a moment to the application of the consensus approach defended here to the various classes of integration intangibles. Before undertaking that discussion, though, I would observe that although the OECD Guidelines do not currently articulate either the interpretive or practical aspects of the consensus approach described above (limited, rather, to the path dependency claims), I believe my approach is broadly consistent with the basic underlying rationales for the arm's length standard stated in the Guidelines. The Guidelines offer a set of reasons for why OECD countries adopted the arm's length standard, which is essentially a historical treatment, and then a separate discussion of why the standard should be maintained (grounded largely in the path dependency aspect of consensus). There is no attempt in the Guidelines to link these matters. However, I believe they are in fact quite closely connected, at least if one takes the broader view of consensus articulated above (that is, consensus over legal ownership rather than over adoption of the arm's length standard itself).

Thus the Guidelines give pride of place as a justificatory matter to the claim that the arm's length standard gives parity of treatment to commonly controlled enterprises and non-commonly controlled enterprises. This is supposed to serve broader tax system goals of efficiency and fairness. As we have seen, this claim has been derided by critics, on the grounds that it fails to take account of the fundamental advantages of integration in commonly controlled firms. If that is right, then we are left only with a path dependent but conceptually flawed result. This criticism misses the mark, however.

Suppose that an integrated group of companies, as theory predicts, realizes a premium over a similarly situated unrelated group of companies operating at arm's length. Suppose further that we are not in long term equilibrium where the unrelated companies are either competed out of existence or are forced into an integrated form to compete. The basic claim of the Guidelines should be read to mean simply that from an efficiency perspective if there is such a premium on a pre-tax basis then so too should there be a premium on an after-tax basis. Note that this does not seem to be particularly onerous requirements as regards the implementation of the arm's length standard. The seeming inability of the method to deal with integration premia is supposed to be a fundamental flaw of the method. But at least according to this metric, observe that the tax burden borne by the premium can take on a very wide range of values and still comport with the underlying goal.

This fits with the basic interpretive stance adopted above. One does not need correspondence to some non-existent independent economic reality regarding parties operating at arm's length hypothetically earning common control premia. Assume the profits *not* associated with gains from integration are allocated and taxed appropriately under arm's length principles. I don't mean to understate the practical difficulty of this, of course, but I make the assumption only to separate issues about integration from other issues. Then on the assumption that there exists some premium from integration, *any* tax burden under 100% on the premium would preserve the proper incentives. This is just to say that on the assumption there is an economic rent the actual allocation assumes no importance from an efficiency standpoint. The paramount concern rather is simply to avoid excessive taxation of the premium, which, I argue is best achieved through a focus on category one intangibles and other recognized assets where there is greater existing consensus about ownership.

A final clarifying point regarding the immediately preceding reference to "excessive taxation" will be helpful here. In this paper I generally follow the language of double tax conventions, which speak of the avoidance of "double taxation." This reflects the simple fact that the paper is meant to function as an academic commentary that might offer some guidance and insight regarding the future evolution of the arm's length standard in the treaty context. But one must be careful with the pejorative use of the term "double taxation" when the question on the table involves economic rents and efficiency claims. There would be nothing inefficient about two jurisdictions claiming a right to tax the rent so long as the total tax levied did not exceed the rent. Thus two taxes on the totality of the same rent, each assessed at a 50% rate, would be an efficient result. Indeed, the result is a better one from an efficiency standpoint then if we were to remove the "double taxation" and have a single jurisdiction tax the rent at a 50% rate. However, my broader concern and focus on "double taxation" here relates to the risk that that when multiple countries claim primary rights to tax the same base, one creates a risk that there can be greater than 100% taxation of the rent portion of the base and higher than desired (though less than 100%) taxation of the non-rents portion of the base. Thus where I use the term "double taxation" to align with the nomenclature in the double tax conventions, the reader should understand this to mean primary overlapping claims to tax base and the ills that may follow from this.

B. *Application of the Consensus Approach*

We now come to the argument that the introduction of novel intangibles would be positively harmful. The basic argument can be stated succinctly, which is simply that we are more likely to get a single allocation of the tax base by focussing on category one intangibles (and other recognized tangible assets and services) then we will if we introduce novel intangibles designed to reflect the gains from unilateral integration, bilateral integration, or common control. The reason for that in turn, is that there is far more existing consensus about legal ownership of currently recognized assets then there would be about the scope of novel intangibles, were they introduced into the transfer pricing analysis. What I would like to do in the remainder of this part, then, is to consider the application of this basic point to each of the three types of integration intangibles I have introduced in my taxonomy.

1. <u>Common Control Intangible</u>.

As noted already, the common control intangible would seem to show the arm's length standard at its weakest, pointing perhaps to an "inherent flaw." One reading of the consensus approach offered above is that under existing applications of the arm's length standard the reporting of gain from the common control premium is discretionary precisely because the method fails to introduce a specific intangible to capture the relevant value. This perhaps suggests the way towards improvement. Why not, that is, elaborate on the arm's length standard by introducing a particular "synergy rents intangible" to capture the value from the common control premium, the quantity *bc* in my working diagram. One might suppose two things here. First, that *any* method of allocation is at least consistent with the arm's length standard, even if not strictly mandated by it, so long as the quantities *ab* and *cd* are preserved to the bases of *Country A* and *Country B*, respectively. Second, that *any* method of allocation would be preferable to leaving the allocation of the entire premium to taxpayer discretion, which would presumably result in lopsided allocations arising from tax competitive pressures. In other words, even if there is no economic truth of the matter as to where the common control premium arises across the two jurisdictions, surely it would be more equitable within the broader treaty context to effect *some* split of the premium across the treaty partners. Tempting as this "solution" may seem I believe it to be fundamentally at odds with the underlying goals of the OECD Model Convention and transfer pricing analysis in the first instance.

We must return here to the guiding principle of consensus, under which one would have to acknowledge that upon introduction of something like a "synergy rents intangible" there will be *no* ready agreement across jurisdictions about the magnitude of this intangible -- about the magnitude of segment *bc* in my working example. This could have problematic consequences in terms of introducing new instances of double taxation. Suppose that under current arrangements (that is, an approach that does not acknowledge something like a synergy rents intangible), we observe consensus across *Country A* and *Country B* that the entities have set prices to effect the allocation such that *A Corp* enjoys profit *ab* and *B Corp* enjoys profit *bd*. Under the interpretation I offer here, this is consistent with the arm's length standard and should give rise to no adjustments. Now suppose that we introduce a synergy rents intangible, meant to effect some clear, and relatively more equitable division of the tax base. For purposes of illustration suppose there is a simple 50-50 split of the premium *bc*. The difficulty is that once we introduce this amorphous novel intangible into the analysis *Country A* may well try to claim that the premium extends to capture part of the value represented by *cd*. Likewise *Country B* may well try to claim that the novel intangible reflects value in the range of profit representing *ab*. Put simply, even if one can instantiate a sharing mechanism such that there is consensus over the relevant split, the novel intangible would seem to give each jurisdiction a powerful new conceptual tool to erode the part of the base properly allocable to the other country under arm's length principles.

This point is further aggravated by the fact that what I am calling the common control intangible and what I have called the unilateral integration intangible represent the same type of value, with the only difference that one involves integration within an entity and the other represents integration across entities. Another way to put this is that both intangibles represent "theory of the firm" value -- value, that is, from allocating resources by hierarchy rather than by market. The particular difficulty we confront here, though, is that the "firm" in the sense of the theory of the firm does not, of course, coincide with corporate entity boundaries. This presents problems for tax policy because such corporate boundaries are highly relevant in legal analysis. In terms of the working diagram, part of the value embedded in the profit *ab* and the profit *cd is* from integration. This fact may well make it all too easy for each jurisdiction, when presented with the prospect of a novel intangible ostensibly covering only the synergy from common control, to claim profits that properly belong to the base of the other jurisdiction. (I return to this point below in the discussion of the unilateral integration intangible but note that what is implicit in my claim about profits that "properly" belong to one jurisdiction is that where an entity has the bulk of its assets and functions in one jurisdiction there may well be pre-existing consensus that the gains from the integration of *those* assets within the entity are properly part of the base of the jurisdiction where the factors are located.)

A general point which I should emphasize here is that I do not mean to paint a rosier picture of the current state of affairs than is actually warranted. In current arrangements, even without the introduction of a synergy rents intangible, jurisdictions are likely to, and do, take sharply different views about the location of points *b* and *c* in my example. If, because of those different views the jurisdictions see *ab* and *cd* as overlapping to some extent, then the prospect of double taxation will result, as in the following diagram, with the bold portions reflecting the amount of base claimed by both jurisdictions.[55]

Diagram 5

Country A View

```
--------------------------------------------------|------------------|-----------------------
a                                                 b                  c                      d
```

Country B View

```
-----------------------|------------------|---------------------------------------------------
a                      b                  c                                                  d
```

But we must treat the analysis, as always, as a comparative one. My point here would be that the introduction of a novel synergy rents intangible would just make matters all that much worse. In the above state of affairs, whatever portion that Country A claims regarding that intangible would, from Country B's perspective, belong to the core of the Country B base and would thus be much less likely to give rise to a corresponding adjustment. And, of course, the exact same

55. As noted above, to make out the claim that this state of affairs results in a problem from an efficiency perspective it would further have to be the case that the overlapping tax claims were reaching the non-rents portion of the base (or subjecting the rents portion to greater than 100% tax). Whether this is the case or not is theoretically indeterminate. On the other hand the idea that such overlapping claims would happen to align with the rents portion of the base seems just about next to impossible as a practical matter.

problem arises in the other jurisdiction, to the extent that Country B makes an adjustment to capture part of what it sees as the profit represented by *bc*.

I am compelled to call attention to a profound irony here. The value underlying the common control intangible is supposed to represent the Achilles heel of arm's length transfer pricing. This line of analysis, however, suggests the exact opposite. At least in one way, the existence of something like a common control intangible is a signal *strength* of the arm's length standard. Observe that under the immediately preceding diagrams the likelihood of double taxation is in part inversely proportional to the size of the common control intangible. At the extreme, where the common control intangible approaches zero, then *any* disagreement about the profit the entities would have earned at arm's length will present the prospect of double taxation (diagrammatically, *ab* and *cd* overlap based on the respective views of the jurisdictions). Value underlying the common control intangible, however, introduces a sort of cushion. As that cushion grows, there is more space for the jurisdictions to take differing views about the locations of points *b* and *c*, without leading inexorably to an overlap and a double tax result. This is another way of saying that there is some affirmative value to the existence of taxpayer discretion in allocating the profit associated with the common control premium. By leaving some amount of profit "off the table" from the perspective of jurisdictional primacy, one decreases the likelihood of conflicting and overlapping claims to tax base.

2. Bilateral Integration Intangible.

The argument regarding the bilateral integration intangible and consensus has much the same flavor as the discussion above regarding the common control intangible, although the particular issues arise in a somewhat different way. Recall that the bilateral integration intangible reflects the value that comes from integrating assets by contract across firms. Thus it is not a "theory of the firm" type of gain. It demands consideration, though, because of course within the bounds of a large multinational enterprise one should expect that some embedded gains from integration of assets that *could* have been achieved by contract.[56] Note that even at arm's length this will present indeterminacy regarding the split of profits because of bilateral monopoly issues. This means that even assuming both a properly applied arm's length standard and available sound comparables, the analysis will produce a range of defensible results. Consider a modified version of the diagram with which we have been working.

Diagram 6

```
---------------------------------|-----|-------|------|---------------------------------------
a                                b     c'      b'     c                                      d
```

Here, the points *a, b, c,* and *d* have the same meanings as before. The new points, *b'* and *c'* reflect issues that arise because of the bilateral integration intangible. Specifically, because of the indeterminacy that arises from comparables analysis with bilateral integration intangibles suppose that *Country A* could defend adjustments that would yield profits to *A Corp* at any point along the segment *bb'* and conversely Country B could defend adjustments that would yield profits to *B Corp* at any point along the segment *cc'*. We see the immediate problem, which is that *Country A* is likely to defend the point *b'* as an appropriate arm's length result and *Country B* is likely to defend *c'*, leading once again to an issue of conflicting views about the outer bounds of the appropriate tax base and thus to the likelihood of double taxation.

As above, one tempting solution might seem to be to limit the comparables analysis in the first instance in a way that takes the gains from integration out of the picture. For illustration, perhaps that would cover non-controversially, and in a non-overlapping way, the

56. The assumption here is that the multinational firm cannot optimize on the contract versus hierarchy margin on a transaction by transaction basis. Thus the reason one could expect to find this sort of embedded gain from contract (rather than it having been contracted out) is that the multinational faces various discrete decisions that encompass a range of transactions, some of which do not present gains from establishing a hierarchy. It is also possible that within a multinational one confronts sufficient divisional autonomy that hierarchy is replaced by an internal market. In that case the gains form integration across divisions also could represent value best captured by my concept of a bilateral integration intangible.

profits represented by *ab* and *cd.* Then as a second step one could then introduce a novel intangible into the analysis, which would account for the additional gains from contractual integration across the entities, along with an agreed treaty mechanism for allocating the profits associated with such an intangible. Again, the appeal would seem to be that with an agreed method of allocation over the profit from the intangible we might seem to land in a better place than under current arrangements. The defect with that line of analysis, however, is that one would still likely lack consensus about the scope of the novel intangible. This leads to the immediate prospect that the novel intangible may accomplish little more than to give jurisdictions new tools to attempt to claim part of the core base represented by segments *ab* and *cd.*

As above I do not mean to suggest that the problems under current approaches are small or easy to solve. The claim rather is a comparative one. Namely, that we are more likely to achieve a reasonable non-overlapping allocation of the tax base by limiting the analysis to legal ownership of category one intangibles, bolstered to the extent necessary with coordinated methods of how to deal with resulting arm's length ranges, than we are to introduce novel and highly indeterminate intangibles into the analysis. Moreover, and consistent with one of the overall premises of the paper, I believe the problems are aggravated here by the complex ways in which gains from integration interact with one another. Although the concept underlying the basic idea of a bilateral integration intangible might be fairly easy to state, separating the value from this type of integration from other types of integration gains will quickly become impossible in practice. That sort of blurring will once again increase the chances that jurisdictions might try to associate value with such intangibles that in fact arises due to other phenomena, such as the unilateral integration intangible.

3. Unilateral Integration Intangible.

Finally, we come to the case of the unilateral integration intangible, which, from the standpoint of the consensus approach, also weighs against the introduction of novel intangibles. Here, because the unilateral integration intangible and the common control intangible represent the same type of value (that is, "theory of the firm" value as opposed to gains from contract), we can return to the simple diagram with which we began.

Diagram 7

```
---------------------------------|-----------------|----------------------------------------
a                                b                 c                                       d
```

The relevance of the unilateral integration intangible is that some of the profit embedded in the quantities *ab* and *cd* represent gains from integration. These are gains that these entities would realize at arm's length; they just happen to arise from integration of assets within an entity. There is no conceptual bar to finding comparables reflecting these gains but as integration within entities becomes increasingly widespread the search for comparables becomes more difficult as a practical matter. I suggested above that one possible solution here might seem to be to separate off the non-integration part of the profit, attempting to locate profit generated by certain elements in isolation, while introducing novel intangibles that seem more readily subject to a comparables based analysis. The appeal of such an approach should again be taken up in a comparative sense, under which I think it is clear that it is not a desirable course.

Note initially that the introduction of such novel intangibles would seem to introduce the same sorts of problems as discussed in the above cases. Precisely because such intangibles are novel and difficult to demarcate with any precision, their introduction would seem to raise the prospect that countries could use them to erode otherwise agreed parts of the tax base. Moreover, attempting to assign value from unilateral integration intangibles to some type of novel asset rather than simply leaving such value as an embedded part of either category one intangibles (or tangible assets or services) would seem to squander a certain amount of pre-existing consensus regarding the allocation of such value. Consider that even before one enters down the road of executing treaties there seems to be some agreement about the way in which integration value is properly associated with the underlying assets which are being integrated. This comes out clearly in a general comparison of arm's length methods versus formulary ones. Returning to the example from above, suppose that *A Corp* has all relevant factors within a single jurisdiction. We tend not even to ask the question about allocation of profits across multiple jurisdictions, *including* any profit attributable to unilateral integration. To see the full import of this add *B Corp*, which also has all relevant factors cited in its jurisdiction of residence. Again we would reach ready agreement that all profits, including those attributable to unilateral integration, are properly allocable to that jurisdiction.[57]

If one accepts these points then it seems that the arm's length standard has a comparative advantage relative to formulary methods to the extent that such companies themselves come under common control and begin to engage in intercompany transactions. Arm's length methods essentially leave undisturbed the existing agreement regarding the allocation of the profit from the pre-existing unilateral integration intangibles. By contrast formulary methods, on this axis, essentially discard this information. We can imagine extreme (admittedly unrealistic) cases to make the point. Suppose *A Corp* and *B Corp* engage in a single intercompany transaction regarding an easy to price widget with abundant third party comparables. It is difficult to see why that single transaction should form the basis of a

57. I hardly see the assumptions as all that extreme. Many corporate bodies do locate the bulk of their factors in a single jurisdiction, choosing to establish corporate subsidiaries for activities abroad. The obvious exception is the case of foreign branches, which I concede raises certain problems. However, I don't think the branch case substantially weakens the import of the point in the text. The premise of the comparative advantage argument in the text is that even in the treaty context -- where you are relying on the treaty to set the substantive terms of the allocation and so it is difficult to get traction making a substantive allocation where everything is arbitrary -- there are some pre-existing aspects which are not arbitrary (or at least are universally agreed) and arm's length methods disturb that on the margin less than formulary methods, as regards integration intangibles. I put the branch case outside of this because I don't think there is any pre-existing consensus absent treaty. Thus my argument of preservation of the status quo consensus does not run in this case, but it does not detract from the overall point that there is some comparative advantage.

substantial reallocation of the profit from pre-existing unilateral integration intangibles that presented no particular problems prior to cross-border integration.[58] But that is precisely what would happen under a formulary approach that adopts a unitary enterprise approach with apportionment factors. Such factors could easily have the effect of shifting the profits from pre-existing aggregation value across the respective jurisdictions. The lesson, I think, is that one should seize on this feature of the arm's length method rather than running from it. If there is existing consensus about integration value following assets then one does best to focus on those underlying assets rather than introducing new ones into the analysis.

I have, of course, designed this initial example with extreme assumptions, where each of *A Corp* and *B Corp* holds all assets in its respective jurisdiction. It may be objected that this misses the core of the problem, as a transfer pricing analysis will have to take account of transfers of the relevant category 1 assets (and tangible assets) across commonly controlled entities. Once again, this may raise difficult problems of application but it is not clear why those difficulties would warrant the introduction of novel intangibles. If *A Corp* is to transfer legal ownership of a category one intangible to *B Corp* in isolation, then the conceptually correct approach is to examine this under a comparables analysis, without reference to integration. If bundles of assets, representing unilateral integration gain are transferred, then this integration gain should be reflected in arm's length transfer prices. This is precisely the type of issue, for example, that is dealt with under current approaches to separate versus aggregated approaches to transfer pricing.[59] If assets are transferred at different times then one must make a decision about whether to bundle them for purposes of determining aggregation value or alternatively whether this aggregation value is reflected down the road in the profits that the company is able to retain

58. This observation is consistent with treatments in the empirical literature which find that the typical apportionment factors proposed for formulary apportionment do a very poor job of explaining differential profit across firms. See Hines, J., "Income Misattribution Under Formula Apportionment," 54 European Econ. Rev. 108 (2010).
59. For a general discussion, see Wittendorf, note 12, pp. 343-363.

from such assets.[60] I do not see that novel standalone intangibles will make an appreciable difference in clarifying these difficult problems, though as I have suggested repeatedly they may well raise new grounds for jurisdictions to overreach in claiming rights to part of the combined tax base.

4. Prescriptions.

The above analysis can now be reduced to some fairly straightforward prescriptions. The overarching point that comes out of the analysis is meant to be a case against the introduction of novel intangibles in transfer pricing analysis as a remedy to dealing with complications that arise from gains from integration. Any such novel intangibles will increase the specter of overlapping claims of tax base as there will be no ready consensus as to their extent. This problem will be aggravated by the way in which gains from integration experienced by multinationals take on different forms, which are overlapping from an economic perspective but distinct from the perspective of a comparables based approach to transfer pricing.

If novel intangibles are the wrong way to go then what is the right way? The analysis above suggests a couple of concrete points. First, the focus in transfer pricing analysis should be on legal ownership of recognized assets categories. Essentially this means that the gains from common control will be allocated by taxpayer discretion following legal ownership.[61] Second, gains from bilateral integration intangibles are best handled by greater coordination of how to deal with arm's length ranges. Third, gains from unilateral integration intangibles are best dealt

60. On temporal considerations, see Wittendorf, note 12, pp. 375-392.

61. This claim introduces a host of other issues which I do not take up in this paper. First, the claim embodies a preference for paying heed to legal ownership rather than "economic ownership" in the associated enterprise context. The brief argument for this is that legal ownership fares better under a consensus analysis and that "economic ownership" is in deep tension with the arm's length standard as unrelated parties will generally not allocate economic gain without contractual remedies. Second, the claim regarding focus on legal ownership may seem to give taxpayers far too much discretion in shifting profit generally. I do not think one can reach any conclusion on that matter, however, without a thorough investigation of the role of CFC legislation and the relevance of non-treaty jurisdictions. Again, that investigation is beyond what I undertake here, but I have address this to some extent in other work. See supra note ___.

with by sharpening of the rules on aggregated approaches and consideration of contractual terms.

* * *

Conclusion

In this paper I have tried to show that although there may be a natural temptation to introduce something like a synergy rents intangible into arm's length transfer pricing in order to shore up the practice against claims that it is inherently flawed, this would ultimately be the wrong path to take. Gains from asset integration are a real and deep problem under arm's length transfer pricing. Introducing new categories of intangibles, however, will likely do more harm than good. The gains from integration have no geographically determinate location. Achieving a single, non-overlapping allocation of such gains then requires some consensus approach, which is an artifact of legal rules and negotiation. Interestingly, we already have some consensus regarding these questions as it relates to integration of assets within corporate boundaries. The introduction of novel intangibles is, I predict, likely to lead do double claiming of base regarding the common control premium and possible double claiming of value from unilateral integration intangibles as well. A preferable course then, is to preserve existing consensus and cede remaining value from common control premia to taxpayer discretion. This is a result which, I have argued, is sound both from a doctrinal and policy perspective.