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FEATURED PERSPECTIVE

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In this article, the authors discuss the BEPS action plans dealing with transfer pricing outcomes and value creation, highlighting several areas that they say need further development and refinement.

In October 2015 the OECD published the final reports of its working groups addressing base erosion and profit shifting. From its inception, one of the primary goals of the BEPS project has been to ''ensure that profits are taxed where economic activities generating the profits are performed and where value is created.''[1] To help achieve this goal, three of the 15 BEPS working groups (groups 8-10) were tasked specifically with ''aligning transfer pricing outcomes with value creation.'' In the post-BEPS world, having the profits of multinational enterprises match up with where value is created in those enterprises can be thought of as the OECD's ''prime directive'' with respect to transfer pricing. (Prior coverage: *Tax Notes Int'l*, Oct. 12, 2015, p. 103.)

How did this come to be? At its essence, the BEPS project is an attempt by the world's major and emerging economies to update the rules on corporate taxation and address the widespread perception that MNEs do not pay their fair share of taxes in today's global economy. Naturally, transfer pricing and global intangibles are important factors in this regard, whether MNEs proactively use them to allocate their profits across jurisdictions as part of their international tax strategies or tax authorities in their attempts to claim what they perceive as their fair share of the tax revenue pie.[2] And since transfer pricing fundamentally relies on the notion that prices on transactions within a corporate group should be the same as they would have been if the transaction had been conducted at arm's length, at first glance the value creation prime directive may seem unproblematic — especially since the OECD has proclaimed its continued adherence to the arm's-length principle throughout the BEPS process.

But as is so often the case when it comes to public policy and economics, things are not so simple in practice. There are at least two reasons to think that the BEPS directive to align transfer pricing outcomes with value creation may, in some circumstances, produce results that violate the arm's-length principle in significant ways. The first problem has to do with the wording of the prime directive, while the second is the substantial risk of its misapplication by tax authorities.

To begin with, what exactly does the OECD mean by ''aligning transfer pricing outcomes with value creation''? While we may have a general idea about the OECD's intent, the BEPS reports never actually define ''value creation.'' This means that the prime directive effectively calls for transfer pricing outcomes to be linked to a concept that can be interpreted or defined in any number of ways.

Given this incomplete explanation of the notion of ''value creation,'' it becomes only too likely that the

[1]OECD, ''About Base Erosion and Profit Shifting,'' *available at* http://www.oecd.org/ctp/beps-about.htm.

[2]For example, by arguing that access to favorable local market attributes such as a talented low-cost labor pool or a favorable regulatory environment gives rise to a valuable intangible.

tax authorities may revert to a closely related concept when trying to ascertain the reasonableness of transfer pricing outcomes, namely value added. After all, value added is a widely understood concept that is already used by many tax authorities around the world. (Think VAT.) But in fact an important distinction should be made between the two terms, one that highlights further potential difficulties with the OECD's prime directive.

Value added is measured simply by comparing the value of inputs with the value of outputs; the difference between the two is the value added by that step in the value chain. The concept is straightforward and particularly easy to apply to traditional manufacturing companies. And since the central concept of the OECD's prime directive is left undefined, it is not difficult to imagine that many will instead focus on the well-understood concept of value added when examining taxpayers' transfer pricing outcomes. This is particularly likely in tax jurisdictions where relatively high value-added pieces of the production process are located.

But the value created within an MNE may involve far more than what is happening at any given stage in the value chain, especially for many of today's companies whose outputs may be services, information, technologies, know-how, brand awareness, and ideas. MNEs amass and put at risk large quantities of capital, set strategic objectives, assemble unique teams of personnel with highly specialized abilities from across the globe, and develop market and bargaining power far beyond the reach of most individuals. These attributes of modern MNEs are often tremendously important profit drivers, even though there may be no stage in the value chain where they are directly measurable.

Another aspect of measurement difficulty is what perspective is most appropriate when assessing value creation for transfer pricing. Should it be measured from the perspective of customers, shareholders, or some other measure that contributes to the MNE's ability to generate taxable profits? The question of measuring value creation goes beyond transfer pricing. As noted by *The Economist*, ''value creation is a corporation's raison d'être, the ultimate measure by which it is judged. Debate has focused on what is the most appropriate type of value for the corporation to create.''[3] The article goes on to ask whether value creation should be based on the value that the stock market gives the company (that is, its market value), the value shown in its balance sheet (that is, the accounting or book value of its assets minus its liabilities), or its expected future performance in terms of profits or cash.

In addition to capital, synergies, and institutional know-how, adherence to the arm's-length principle must also consider other factors such as the law of supply and demand, bargaining power, and appetite for risks. Many in business point to the concept of ''value capture'' as an important feature of arm's-length dealings, which is separate and distinct from value creation. Value capture is the ability to extract rents without necessarily creating value. Bargaining power and risk appetite play key roles in value capture. When one is considering a result in any third-party negotiation, the best alternative to a negotiated result and the relative bargaining power of the parties are key drivers to the individual's or entity's ability to capture value. One can easily imagine that a parent company or owner of important intangibles is likely to have significant bargaining power to achieve a more favorable result in its negotiations with a local-country business such as a distributor or retailer.

To understand how a reliance on the notion of value creation may put the prime directive at odds with the arm's-length principle, consider an illustrative example. Suppose a pharmaceutical company hires a research team to develop a new drug, analogous to a contract research and development entity. If things go well, the value added by the research team will be far greater than its compensation. In fact, that is the goal of the corporation. Yet even though the compensation paid by the MNE to the research team is hoped to be much less than the value captured by the company, the arrangement is, by definition, arm's length.

Why don't the researchers demand and receive compensation equal to the value they add to the firm? Or put another way, why don't they independently develop the new drug so that they can capture more of the value they have created for themselves? Because the other ways in which the enterprise creates value — by putting capital at risk, by assembling a team with the other functions, institutional know-how, and corporate culture supporting innovation necessary to derive value from a new drug, and by having the market clout to fully capitalize on the new product — make the entire endeavor more successful for both the firm and the team when they work together.

In the absence of a clear definition of the term ''value creation,'' a transfer pricing analysis that follows the OECD's prime directive may well note that the bulk of the value added for this firm is in the R&D and marketing departments, with perhaps a small (''routine'') amount attributable to corporate functions. The analysis, without considering a broader perspective that would include value capture, may conclude that the MNE's profits should be distributed likewise. Perhaps unsurprisingly, countries like India and China would be particularly pleased with such an analysis.

Yet an analogous, hypothetical corporate entity could be constructed entirely of arm's-length arrangements, yielding a completely different allocation of the firm's profits across the value chain. The hypothetical

[3]''Value Creation — The Ultimate Measure by Which a Company Is Judged,'' *The Economist*, Nov. 20, 2009.

firm could use uncontrolled third-party contractor companies to perform research, outsource most of its administrative functions, and hire a marketing firm to bring its products to market. In a sense, we've replaced a traditional MNE with a ''virtual'' MNE. (Note that this is an arrangement that we do observe in today's economy in some industries.) Under this scenario, each of the third-party service providers would earn a return that is more or less ''routine'' (at least for the types of services they provide), while the majority of the remaining profits from selling the new drug would be captured by the central corporate entity — the clear, risk-taking ''entrepreneur'' with the strongest bargaining leverage in this value chain. Since these arrangements among uncontrolled third parties are clearly arm's length, neither the OECD nor any tax authority could dispute this outcome.

By facilitating transfer pricing analyses that may yield conclusions at odds with the arm's-length principle, the OECD's prime directive thus clearly has the potential for imposing substantial costs on companies that choose to keep functions in-house. The fact that in many situations MNEs prefer not to outsource certain functions indicates that there are often efficiencies to be had by forming a multinational corporate group. That is, after all, why we actually observe MNEs in the first place. By effectively penalizing traditional MNEs compared to fully outsourced, virtual MNEs, the BEPS emphasis on aligning transfer pricing outcomes solely with the notion of value creation therefore has the potential to impose significant efficiency costs on the world economy.

While we agree that value creation is an important consideration in evaluating the arm's-length nature of controlled transactions, placing this concept at the center of the OECD's transfer pricing guidelines may have the unintended consequence of imposing significant burdens on MNEs due to the scope it grants for widely different interpretations. One implication of this is that the careful preparation of a thorough functional analysis — one that devotes as much attention to identifying synergies, sources of market power, creation of intangibles, value capture, and the incidence and management of risks as it does to the distribution of functions within a MNE — will be more important for taxpayers than ever. But more fundamentally, this issue suggests that MNEs, transfer pricing practitioners, and the OECD BEPS team still have work to do to develop additional frameworks that encourage the consideration of the full range of an MNE's possible profit drivers and the arm's-length principle as we develop, implement, analyze, and evaluate transfer pricing arrangements. ◆