In this article, the revised interpretation of the arm’s length principle on risk allocation as presented in the BEPS Final Report on Action 8-10 is discussed. By analysis of the main points, the author contests this interpretation and suggests an alternative approach.

1. Introduction

The BEPS Final Report on Actions 8-10 contains a revised interpretation of the arm’s length principle on risk allocation. This report should enable tax authorities to combat profit shifting through the transfer of risks and the associated risk premium to low-tax group companies. According to the OECD, risk allocation must be based on the activity of risk assumption and risk management – not on the contractual allocation of risk.

In the author’s opinion, the OECD has taken the wrong direction with the revised interpretation. Indeed, risk can be a means of profit shifting, but the revised interpretation contradicts the fundamental concept underlying the arm’s length principle, is unnecessary and will not eliminate those drivers of profit shifting that it seeks to combat. Instead, the OECD should have eliminated the real cause of profit shifting, i.e. the opportunities for MNEs to assign to their subsidiaries the diverging risk projections and risk attitudes. Such divergent risk attitudes and risk projections do not add value to an MNE, but are the single most important cause of profit shifting. Taking away this opportunity would require that article 9 of the OECD Model Convention (OECD Model) be amended by adding that entities, when entering into a related-party transaction, are assumed to have the same expectations and the same risk attitude.

2. The Revised Interpretation

2.1. Why a revised interpretation on risk allocation?

Profit is the reward for risk assumed (as well as for activities performed and assets used). The party involved in a transaction who assumes the risks will be rewarded for assuming those risks when claiming a large piece of the profit pie. Profit can therefore be transferred by transferring risks from one company to another. Risk allocation, however, is subject to manipulation. First, risk can be transferred fairly easily from a high-tax company to a low-tax company by contract and capital allocation. For MNEs that wish to shift profits to lower-tax jurisdictions, the transfer of risk is more attractive than moving people and assets, as people are bound by location while contracts and capital are fluid. Second, risk is opaque for many tax practitioners. The pricing of risk requires assessments of unknown future events that may be difficult to identify, the probability of which may be difficult to evaluate and may be subjective and untraceable.

Proper risk allocation, based on realistic estimates of good and bad chances, will lead to arm’s length profit allocation, but these estimates can be manipulated. When allocating risks to a low-tax jurisdiction, MNEs have an interest in overstating the negative risks and understating the positive, and may thus overstate the risk premium allocated to the low-tax company. Or as Marlies de Ruiter puts it: “if you look at […] risk […] in low-tax jurisdictions, […] what you see is that there is a huge profit. So it doesn’t take a random walk at all”.3

2.2. OECD: Contractual allocation subordinate to functionality

In new paragraphs 1.56 through 1.106 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, the OECD presents a six-step plan for the arm’s length pricing of risks. According to the OECD, risk allocation must be based on functionality, i.e. the human activity of reviewing, assuming and managing risks. The six steps are as follows:

(1) the MNE must identify economically significant risks with specificity;
(2) the MNE must determine how the risks are contractually allocated;
(3) the MNE must determine, through functional analysis, how the associated entities operate in relation to risk assumption and management, i.e. (i) which entity performs control functions and risk mitigation functions, (ii) which entity encounters the upside and downside consequences of risk materialization and (iii) which entity has the financial capacity to absorb these consequences;
(4) the MNE must determine whether the functional analysis is consistent with the contractual risk allocation, i.e. whether the parties follow the contractual allocation and whether the party assuming risks con-

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Footnotes:

1. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015), International Organizations’ Documentation IBFD.
2. OECD’s Head of the Tax Treaty, Transfer Pricing and Financial Transactions Division, Centre for Tax Policy and Administration.
controls the risks and has the financial capacity to absorb those risks;
(5) the guidance on risk allocation must be applied if the party assuming the risks does not control the risks or does not have the financial capacity to absorb risks; and
(6) the taxpayer must price the transaction taking into account the risk allocation.

At first glance, it appears as if the contractual allocation of risk remains decisive because the series of steps start by determining the contractual risks. However, this is misleading: from Steps 4 and 5, it follows that if the analysis under Step 3 is inconsistent with the allocation in Step 2, Step 3 takes priority. The really detrimental step, however, is Step 3, in which the OECD argues that arm’s length risk allocation is determined by the question as to which contracting party controls the risks. According to the new paragraph 1.65, risks are to be allocated to the party that is functionally involved, i.e. the party that has (i) the capability to make decisions to take on, lay off or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with actually making those decisions. According to paragraph 1.86, a decision should also be made as to which party has the financial capacity to assume risk. This suggests that the legal form of risk allocation remains a determining factor: contractual allocation and a company’s capitalization are both the result of the legal form chosen by the MNE for risk allocation.

Again, however, the revised interpretation is misleading as, according to the OECD, both questions (as to which party contractually bears the risk and which has the financial capacity to assume risk) are to be answered based on functionality. According to the OECD, a contract should allocate risks only to the party having the functionality to assume the risks. It is therefore not relevant what parties have agreed, but rather what they should have agreed. Nor is the actual capitalization of the related company relevant, but rather the capitalization to which the company can be assumed to have access, based on its functionality: the OECD defines the financial capacity to assume risk as "access to funding to take on the risk or lay off the risks." According to the revised interpretation, any company with the functionality to control risks will have access to capital that will allow it to assume risks.

If a company lacks the functionality, but has the capital to bear risks, the risks and remuneration – according to the OECD – should be allocated to the related party that does have the functionality. A capital-rich company lacking functionality, however, should be allocated only a risk-free remuneration, meaning that the contractually allocated risk remuneration is irrelevant. This eventually means that functionality is the decisive factor and a contractual allocation may be followed only if the contract allocates the risks to where the OECD wants the risks to be allocated.

3. Why the Revised Interpretation Is Wrong
3.1. The interpretation conflicts fundamentally with the arm’s length principle itself

The basis of the arm’s length principle is that a company is treated as a separate entity for taxation, irrespective of its functionality and of whether it is part of a larger group of companies. This “separate-legal-entity approach” is also the underlying principle of the tax systems applied by all industrialized economies. The separate-legal-entity approach attributes the results of human action to the company as if the company itself had performed these actions. The question is whether the action of the person can be considered to represent the company, i.e. whether the company is bound by it, not whether the company has the functionality to be bound by the representative. In fact, the representation itself forms the functionality. This “attributed functionality” is a fundamental choice underlying the taxation of corporate profits and applies irrespective of which legal form the representation has, e.g. the form of an employment contract, a management agreement, an outsourcing assignment or an agency agreement. The suggestion arising from the interpretation by the OECD is that functionality can be achieved only if the actions of the company are performed by employees of the company in the country where the company resides.

It remains completely unclear as to why other forms of representation would have a different result. As will be seen in section 3.2.1., functionality is indeed relevant for determining where the company resides or where it has a taxable presence through a permanent establishment, but the concept is useless for determining transfer prices in related situations. A simple example will demonstrate how the OECD interpretation contradicts standard situations of attribution. Suppose that an individual contributes his or her portfolio investments to a wholly-owned company. Such a company has no functionality: the individual controls the size of the company’s assets by contribution and distribution, and he or she sets the company’s risk attitude and investment strategy. For tax purposes however, the investment income is attributed to the investment company, not to the individual. If it were different, the whole corporate tax system would become obsolete.

3.1.2. Functionality approach contradicts other rules and concepts

How deeply the attributed functionality is rooted in the tax system can also be demonstrated by the extensive sets of rules that many countries apply to take away the unwanted

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4. OECD, Actions 8-10 Final Report, supra n. 1, paras. 1.96 in conjunction with 1.102 and 1.103.
5. OECD, Actions 8-10 Final Report, supra n. 1, para. 1.64.
6. OECD, Actions 8-10 Final Report, supra n. 1, para. 1.64.
7. OECD, Actions 8-10 Final Report, supra n. 1, para. 1.103.
8. Some countries have look-through provisions that allocate the income back to the individual to prevent individuals from sheltering investment in shell companies, but these provisions underline the system. Such look-through provisions would be unnecessary if functionality were the norm.
side-effects of the system. The author mentions just three categories of rules:

1. Look-through provisions that allocate the income back to the individual behind a passive investment company in order to prevent investors from sheltering investments in shell companies;
2. Controlled foreign corporation (CFC) provisions that require the parent company of a CFC to treat the (mostly passive) income of a CFC as fictitiously distributed to the parent; and
3. Rules that subject the consolidation of corporate profits into the parent company to strict conditions.

The starting point is that—consistent with the concept of attributed functionality—no consolidation is allowed, unless these strict conditions are met.

All these rules would have no meaning if functionality were the norm. The functionality approach of the OECD is in complete contradiction to the tax system. 10

Ironically, the approach of the European Commission to attack tax-efficient structures within the European Union also underscores the concept of attributed functionality. The Commission’s Fiat decision11 could never have resulted in the conclusion that the Luxembourg company should have been taxed on profit it lawfully made if the functionality approach had been applied.

Finally, the rulings of the Court of Justice of the European Union (ECJ) in State aid cases concerning the taxation of profits also assume the attributed functionality; more specifically the Gibraltar case.12 In that case, the European Commission contested the introduction by Gibraltar of a tax system that would do exactly what the OECD now wants to achieve: an entity resident in Gibraltar would effectively not be subject to a profit tax if it lacked functionality in Gibraltar. Gibraltar had designed a tax system in which a Gibraltar company would be subject to a payroll tax, a business property occupation tax and a top-up tax on income from financial services and a registration fee. The overall tax liability would be limited to 15% of a company’s profit calculated in accordance with internationally accepted standards. The effect of the tax system would be that companies earning profits in Gibraltar on their assets owned by the company would not pay any tax as long as they had no employees or business property in Gibraltar. No employees or no business property means no functionality, and therefore the Gibraltar system would result in profit taxation based on the functionality approach that the OECD advocates: no taxation if the company lacks functionality, taxation if it does have functionality.

3.1.3. The functionality approach contradicts other BEPS Actions

The revised interpretation is also inconsistent with other BEPS Actions that the OECD itself proposes. Take, for example, Action 6, which aims to counter treaty abuse by conduit companies. If the revised interpretation were applied to these companies (which normally have no employees or offices and thus—by definition—lack the functionality to manage the risks associated with their assets), the question arises as to why a limitation on benefits provision or a principal purpose test would be necessary to deny such conduit treaty benefits.

If the functionality approach were indeed the norm, the proposed anti-treaty shopping measures would be obsolete. The income of the conduit should then be allocated to the company that has the functionality to manage those risks, and not to the conduit. Action 6 emphasizes that the interpretation contradicts the concept accepted worldwide that underlies the taxation of companies, i.e. that the legal entitlement to income is the rule and that an explicit exception is needed in order to eliminate the unwanted consequences of the rule. An interpretation cannot serve as such an exception, as Action 6 demonstrates.

3.1.4. OECD denies the principal-agency structure inherent in Western economies

The OECD claims that a person with financial capacity to bear business risks would be willing to accept these risks

10. Controlled foreign company rules and passive investment company rules often reallocate income from passive shell companies back to the shareholders to attack tax planning. Such rules would not be necessary if the OECD were right to claim that the arm’s length remuneration of a capital-rich company is just the risk-free rate.
only if that person also has the functionality to manage the risks. This, however, is in contradiction to economic reality: modern capitalism is built on principal-agency relationships in which the capacity to fund investments and manage the risks of those investments is separated. Examples of these principal-agency relationships include investment funds, private-equity funds and listed companies. The separation between risk management and risk assumption is the basis of these relationships. The investment manager has the functionality to control the risks on behalf of and for the account of the investor, but does not assume the risks.

It is by definition the legal form of the principal-agency relationship that determines the tax consequences of that relationship. If the relationship takes the legal form of an individual asset management assignment, the assets and associated risks are attributed to the investor. If, however, the agency relationship is structured as a fund with legal personality, the assets and associated risks are attributed to the fund entity. Whatever the legal form of the relationship, however (individual asset management assignment or fund), the asset manager managing the risks never receives the risk premium that is the remuneration for assuming the risks, whereas this is what the OECD claims that is happening between unrelated parties. That risk premium is either received by the fund (and taxed at the fund level) or by the investor (and taxed at the investor level).

The claim by the OECD that in arm’s length situations, the party controlling the risk will demand the risk premium is totally unfounded.

3.2. The functionality approach is unnecessary

3.2.1. The existing rules are sufficient to attribute taxation rights based on functionality

The aim of the OECD’s functionality approach is to combat unwanted risk transfers and link profit allocation to the place where decisions about risks are made. As discussed in section 2.1., there are good reasons to fight non-arms length risk transfers. However, the OECD appears to overlook the fact that current tax treaties provide tax authorities with sufficient means to include functionality in the attribution of taxation rights between contracting states. The concepts of “effective management and control” and “permanent establishment” both take the human activity of risk management into account, (see section 3.2.2.). In addition, various economic concepts for pricing risk provide practical tools for attacking manipulated risk allocation, without the need to introduce a controversial interpretation of the arm’s length standard, as defended by the OECD (see section 3.2.3.).

The author therefore believes that the misuse of risk allocation was not the result of a lack of means for the tax authorities, but of the lack of utilization of these means. The OECD would do better to Advocate improving the systems current use, rather than disrupting it. Why repair a system that is conceptually not broken?

3.2.2. Effective management and branch account for functionality in attributing taxation rights

A company’s residence is the basis for attributing the primary right to tax a company’s profit and is determined on the basis of effective management and control. In addition, the concept of permanent establishment attributes the right to tax a company’s profit linked to functionality to the state where the functionality is located. Thus, if a company lacks functionality in one state, but has functionality in another, articles 4 and 5 of the OECD Model allow the other state to tax the profits linked to that functionality by correctly arguing that the company is either resident or maintains a permanent establishment therein. It would not be necessary to redo the functionality exercise for pricing related-party transactions.

3.2.3. Tax authorities do not utilize available quantitative methods for pricing risks

As discussed in section 2.1., MNEs are better positioned than tax authorities to evaluate the risks involved in their business operations, and may indeed be tempted to overstate negative risks and underrate positive risks to manipulate profit allocation between related entities. This problem, however, is not solved through the functionality approach advocated by the OECD; companies with the relevant functionality to manage and control risks can be allocated overstated risks even more easily than companies lacking that functionality. Manipulated risks can, however, be revealed and eliminated by using risk analysis methods, such as sensitivity analysis, risk modelling and Monte Carlo simulation. These methods are consistent with existing economic practice for pricing risk and comply with the existing transfer pricing guidelines.16

However, the author has never seen tax authorities apply these techniques or demand from MNEs that they support the risk allocation in related-party transactions through a rigorous application of these techniques. In paragraph 1.71 of the Actions 8-10 Final Report, the OECD addresses the issue of the economic significance of risks that, according to the OECD, must be “identified with specificity.”17 That, however, is the only guidance. The author believes this to be very bleak. Clear and practical guidance on how to identify, classify and price significant risks would have been of greater assistance to transfer pricing practice than a controversial theory on functionality.

3.3. The revised interpretation will not be effective

3.3.1. Divergent application is the real risk

Countering tax avoidance requires that all tax authorities apply the rules consistently and unambiguously. This is even truer for rules concerning the allocation of risk: for many tax practitioners, risk is an opaque subject, as is its allocation. An ambiguous interpretation will amplify opacity and make the interpretation vulnerable to exploita-


17. OECD, Actions 8-10 Final Report, supra n. 1, para. 1.71.
The US tax policy over the last two decades has been to support US multinationals operating outside the United States under more competitive tax conditions than their local competitors. The policy tolerates US multinationals keeping their foreign profits offshore if not repatriated to the United States, which acts as an incentive to keep foreign profits low taxied by shifting profits from foreign high-tax jurisdictions to foreign low-tax jurisdictions.19

The revised interpretation will allow the United States to continue this policy. The standard technique for US multinationals to bring non-US patent income offshore is that an offshore company buys into a cost-sharing agreement for the part of a US patent that is used to generate foreign income. From that moment on, the foreign patent income is no longer taxable in the United States because section 861 of the Internal Revenue Code subjects royalty income of a foreign entity to US taxation only in so far as the royalties are received from sources within the United States. The offshore company will not be taxed for the foreign-source patent income, even if the company is managed and controlled inside the United States.20

18. Those watching the US Senate Finance Committee Hearings “International Tax: OECD BEPS & EU State Aid” (www.finance.senate.gov/hearings/international-tax-oecd-beps-and-eu-state-aid) will get the impression that the US Treasury Department’s stake in the BEPS Project was foremost and above all about protecting the interests of US multinationals against “aggressive” tax authorities of other OECD member countries, rather than avoiding profit shifting. See also the interview by BNA with Robert Stack, Deputy Assistant Secretary (International Tax Affairs) US Treasury, available at www.bna.com/videos-m57982058714.

19. A recent US Treasury White Paper claims that the profits kept offshore are US profits, not foreign profits. US: Treasury Dept., The European Commissions Recent State Aid Investigations of Transfer Pricing Rules (24 Aug. 2016). The present author disagrees. Under Treasury Regulation sec. 1.482-7, a buy-in payment forms the arm’s length remuneration for future foreign income generated by the patent that is attributable to the patent existing at the moment of the buy-in. From the moment of the buy-in, the income generated by the patent is the foreign entity’s income, i.e. foreign income, not US income – otherwise no arm’s length payment would need to be made. If the foreign income is subsequently distributed by the foreign entity to the US parent, the United States will indeed tax these dividends again and give credit for the foreign tax attributable to the foreign profit from which those dividends are paid. The mere fact that the United States grants a credit for foreign tax underscores the fact that the royalties are foreign, not US.

20. The US system of taxing companies is not based on a company’s management and control, but on its jurisdiction of incorporation. A foreign company will therefore not be subject to US taxation, even if all board decisions are made in the United States.
them. Mnookin, Peppet and Tulumello identify five differences that create value in a transaction, two of which concern risk. First, the parties may have different views on the future: “I believe the stock market will go down, you believe it will go up. Therefore I sell you the stock that I hold.” Second, parties may have different risk preferences: “I give preference to a more stable investment yield, whilst you give preference to the opportunity of a high investment yield. Therefore I swap the risky shares that I hold against the less risky bonds that you hold.” In arm’s length situations, parties in a transaction may realistically have different risk projections and risk preferences, but in MNEs, each party to the related-party transaction can be assumed to contribute to the overall objectives of the MNE.

How realistic is it, therefore, to assume that the various parties within an MNE make different risk projections or have different risk attitudes? Would it not be more realistic to assume that the various parties have the risk expectations and risk attitudes of the MNE as a whole? The transfer of risk between related parties is based on the two differences, but is not at functional within an MNE. The arm’s length principle in its current form does allow MNEs to re-allocate risk by assigning the various entities different risk projections and risk preferences, although these differences do not contribute to the overall profit of the MNE, at least not if risks are being transferred between these related entities.

4.2. Changing the arm’s length principle by converging risk expectation and attitude between all MNE entities

The real cause for profit shifting through risk transfers is that the arm’s length principle allows MNEs to assign various entities with diverging risk expectations and risk attitudes for the same transaction. High-taxed entities will be assumed to have a pessimistic view and/or risk-averse attitude, while low-taxed entities will be assigned an optimistic view and an attitude with a high risk tolerance. The OECD acknowledged this phenomenon in the Action 9 Discussion Draft by proposing ‘special measures’, but eventually withdrew those measures that would have attacked this opportunity for profit shifting. Instead of these special measures or the controversial revised interpretation according to the current principle, the author believes that the OECD should have proposed a simple but effective amendment to article 9 of the OECD Model that all parties involved in a transaction are assumed to have the same view on risk expectations and have the same attitude towards risk. If all parties are assumed to have the same risk expectations and attitude to risk, the transfer of risk would be useless. This change would indeed require that article 9 and all treaty provisions based on it be amended, which would have been a more robust solution than a controversial interpretation that contradicts the arm’s length principle itself. The amendment could have been made, together with the multilateral instrument for implementing Action 15. A missed opportunity and not very functional.

22. The five differences are: (i) differences in available resources, (ii) differences in absolute preferences, (iii) differences in relative preferences, (iv) differences in expectations and (v) differences in risk preferences.
23. The MNE as such may have a diversification strategy in which it invests in enterprises with non-correlated risk profiles so as to optimize the overall mix between risk and return of the MNE. Risk transfer between entities will have no positive effect in this strategy, as risk allocation between these entities is a zero-sum-game; the gain of one is the loss of the other.