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“INTERNATIONAL TAXATION OF RISK”

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International Taxation of Risk

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Abstract

The allocation of risk and of the income from risky investment and activities belongs to the central topics of international tax policy today. This fact is highlighted by the current BEPS initiative of G20 and OECD which casts doubt on the recognition of contractual risk allocation within multinational groups and its impact on profit allocation between separate entities within these groups. It is largely felt that “risk shifting” provides the basis for “profit shifting” by multinationals to the detriment of states and domestic competitors.

This article tries to address the topic in a generalized fashion. Starting from the findings of economic research with respect to the interaction of risk and taxes in a domestic setting, it draws conclusions for the international situation. It analyses the fiscal interests of source states and residence states and points out that – while risk shifting is essentially tax-neutral – there are three major areas of concern which have to be discussed: asymmetrical risk allocation (i.e. lack of balance between upside and downside potential), taxation of risk premiums and the tax treatment of “hidden intangibles”, i.e. the distinction between risky income and rents. Furthermore the article supports the relevance of ownership and funding for the allocation of risk and income and warns against overstating the notion of “control” and “real activities” when it comes to the recognition of risk. Finally, it should not be overlooked that states benefit from the lack of full loss-compensation in their national tax systems which allows them to tax volatile profits while not giving full credit for volatile losses.

Keywords: Tax Law, International Tax Policy, Risk and Taxation, Profit Allocation, Contractual Risk Allocation, Transfer Pricing, Arm’s Length Approach, Double Taxation Conventions, Risk Premium, Intangibles

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I. Risk Allocation and the Taxation of Multinational Enterprises

Business income consists of three major elements: at the bottom line a risk-free rate of return on the invested capital, secondly infra-marginal income from economic rents (e. g. from location-specific natural resources, from proprietary intellectual property or from other monopolistic income-generating assets) and – last not least - income from risky activities, where the income is dependent on uncertain future developments like the success of innovative research, the exploitation of a new market, the reliability of the existing workforce or the stability of the political environment².

Each of these three elements poses specific challenges to the design of national and international tax law.

- The treatment of the risk-free rate of return has been widely discussed in the context of the “income tax versus consumption tax” debate where a tax exemption for the mere time-value of money plays a pivotal role³. Both at the national and the international level, this debate has currently switched its focus to the legislative option to introduce an “allowance for corporate equity”⁴, i.e. to allow for a tax-relevant deduction of notional interest on corporate equity, thus strengthening inter-temporal neutrality and providing equal treatment of debt and equity at the same time.

- The domestic taxation of economic rents is uncontroversial as such. The small debate is largely focused on the true “source” of this income (capital or labor or something else)⁵. But from a cross-border perspective there are still open issues as regards the delineation of taxing rights between countries, e. g. when rents derived from the exploitation of intangible assets, market power, a customer base or a synergistic organization within the firm are generated in an international context⁶.

- The effects of taxation on risky investment in a domestic situation have been described extensively by economic writers, beginning with a seminal article by Domar and Musgrave in 1944⁷. Yet the impact of risk on international taxation in general has not been studied at a large scale. In legal writing, Mitchell Kane’s article on “Risk and Redistribution in Open and

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Closed Economies“, published in 2006\(^8\), stands out as a major analysis of risk-taking in multinational enterprises from the perspective of international tax law. On the other hand, there is widespread concern that the contractual allocation of risk within a multinational enterprise contributes greatly to arbitrary shifting of profits and losses between affiliated companies and branches, thus enabling companies to manipulate the allocation of corporate income to certain jurisdictions and to minimize the overall level of the tax burden for the multinational enterprise. Renowned writers like Richard Vann have therefore pleaded for non-recognition of these contractual arrangements, leaving behind the paradigm that group companies have to be treated by tax law like independent entities under the arm’s length standard\(^9\).

This position is gaining ground in international tax policy circles. In its February 2013 report “Addressing Base Erosion and Profit Shifting”, the OECD makes the following statement:

“Arrangements relating to risk shifting raise a number of difficult transfer pricing issues. At a fundamental level they raise the question of how risk is actually distributed among the members of an MNE group and whether transfer pricing rules should easily accept contractual allocations of risk. They also raise issues related to the level of economic substance required to respect contractual allocation of risk, including questions regarding the managerial capacity to control risks and the financial capacity to bear risks. Finally, the question arises as to whether any indemnification payment should be made when risk is shifted between group members.

In summary, the Guidelines are perceived by some as putting too much emphasis on legal structures (as reflected, for example, in contractual risk allocations) rather than on the underlying reality of the economically integrated group which may contribute to BEPS.”\(^10\)

There exist major examples where the allocation of risk is largely seen by governments as merely detrimental profit shifting\(^11\). One example is the establishment of a “captive insurance” company which is set up in a low-tax jurisdiction and assumes risk connected to the business activities of other members of the multinational enterprise on a contractual basis\(^12\). Other examples are commissionaire arrangements between the parent company and a local sales company or a contract manufacturing arrangement between the parent company and a local producing unit\(^13\). In these cases, the local taxpayers “only” earn a fixed rate of return on their investment while the opportunities and risks from the overall business are concen-

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\(^10\) OECD, Addressing Base Erosion and Profit Shifting, 2013, S.42 f.


trated at the level of the parent company. This strategy has gained wide prominence with regard to intangible assets like patents or trademarks which are – on the one hand – subject to high volatility of return and therefore prone to high risk but can – on the other hand – be easily shifted between companies and jurisdictions. In particular the exploitation of R&D activities on a contractual basis, which allocates both the upside and the downside potential of research performed in a high-tax country to a group member in a low-tax country, has been widely regarded as not being in line with the concept that profits should be taxed where the underlying business activity is performed. Recent OECD work on the Transfer Pricing Guidelines, in particular the novel chapter on “business restructurings” and the current discussion draft on “intangibles” provides some guidance as to how these arrangements can be tested under a sophisticated arm’s length standard. So far, the general policy of OECD is to accept contractual risk allocation as such but to restrict the leeway for the involved members of an MNE by applying more and more demanding examinations.

One path of doing away with intragroup-risk for tax purposes is the introduction of formulary apportionment as the main factors of the allocation formula (real capital, workforce, sales) are rather unaffected by contractual risk shifting within the group. This is part of the CCCTB proposal of a Directive which is meant to reform taxation of corporate groups within Europe. At the OECD level, on the other hand, there seems to be no basis for such a far-reaching reform. As the OECD states in its recent “Action Plan on Base Erosion and Profit Shifting”,

“there is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward; it is also unclear that the behavioural changes companies might adopt in response to the use of a formula would lead to investment decisions that are more efficient and tax-neutral than under a separate entity approach.”

Therefore, OECD has proposed to the G20, that work on intra-group transactions should focus on an incremental improvement of the current system of separate accounting and transfer pricing. In this context, OECD points out that artificial profit shifting stems from some specific arrangements, including “contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties”. Under Action 9 of the proposed Action Plan OECD commits itself to

“develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractual-

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14 The traditional view is expressed in OECD Transfer Pricing Guidelines 2010 para 7.41.
15 OECD Transfer Pricing Guidelines 2010, Chapter IX, in particular para 9.10 et seq. (“Special considerations for risks”).
18 OECD, Action Plan on Base Erosion and Profit Shifting, 2013, S.14; see also OECD Transfer Pricing Guidelines 2010 para 1.14 et seq. (“Maintaining the arm’s length principle as the international consensus”).
ly assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense deductions and other financial payments.”\textsuperscript{20}

This action plan has been endorsed by the July 2013 meeting of the G20’s Finance Ministers and Central Bank Governors. They “acknowledge that effective taxation of mobile income is one of the key challenges. Profits should be taxed where functions driving the profits are performed and where value is created”.\textsuperscript{21}

Against the background of this global debate on tax policy, this article tries to bind together the fundamental framework developed with respect to the taxation of risky investment in general and the current policy issues shaping the international taxation of business income and in particular the recognition of contractual risk allocation within a multinational firm. This requires an understanding of the underlying economic features of both international taxation and multinational firms and an understanding of the legal principles applicable in the field of tax and corporate law. Therefore, the widely accepted analysis of the taxation of risky investment in a domestic context has to be expanded into an international context – both for contractual arrangements between independent enterprises and with regard to multinational enterprises. In particular we have to come up with a clear analysis of the material interest countries take in taxing income from risky investment rather than income from less risky activities.

II. Private Risk-Taking and Public Tax Revenue

1. Domestic Situation

One of the recurrent features of the debate is the assumption that “contractual risk shifting” between companies resident in different states also leads to “corporate profit shifting” between these taxable units and – in the end – leads to “fiscal revenue shifting” between the involved jurisdictions\textsuperscript{22}. But why do countries prefer a local subsidiary of a foreign parent company to act as a “fully-fledged distributor” (bearing the market risk of sales to the full extent) and not as a “commissionaire” (bearing only the risk to gain or lose the “commission” or a fixed consideration)? Why do countries want to tax local R&D units on the basis of the full but highly volatile outcome of their activity and not on the basis of a secure and regular income from fixed remunerations paid by a foreign-based affiliate? And why do countries plead for non-recognition of contractual risk allocation with captive insurance entities as this reduces the probability that taxable losses are available for set-off? The answer requires a look at the underlying economics.

\textsuperscript{20} OECD, Action Plan on Base Erosion and Profit Shifting, p.20 (Action 9).
\textsuperscript{21} Meeting of Finance Ministers and Central Bank Governors, Moscow, 19-20 July 2013, Communiqué, para 18.
When Domar and Musgrave wrote their seminal article in 1944, they put forward the proposition that income taxation on risky investment transforms the State into a “dormant partner” of the investor23. Given a linear tax rate and given full loss offset (including a negative income tax on losses) the State will participate in a symmetric fashion both in the profits exceeding the risk-free rate of return and in the downside potential stemming from the volatility of returns on risky investment. This has led them to the conclusion that investors will simply increase the size of their investment in order to align the after-tax output to the pre-tax output in the original situation24. This analysis has been confirmed over and over again25. Given the symmetry of the upside and the downside of any investment (leaving economic rents aside) this seems to support the view that the State cannot win from the attraction of risky investment as such. In a 2004 article, David Weisbach has reached the conclusion that any taxation of capital income in general will end up in the taxation of the risk-free rate of return as all tax claims on the upsides and downsides of risky investment will basically level each other out26.

If this is true, no State should really be interested in the taxation of risk-related returns. The claims of OECD and G20 would be largely unfounded. To put it differently: risk shifting would mean a transfer of a symmetric set of upside potential and downside potential which has no “value” beyond the underlying risk-free rate of return. But this is exactly what States are entitled to tax anyway in a risk-stripped situation. The only question left to them seems to be whether to grant an allowance for this risk-free rate of return (as proposed by the advocates of a consumption tax).

While this analysis basically holds27, there are three major qualifications which support a different view:

- First of all, it is evident that the State becomes more interested in the attraction of risky investment if the fiscal effects of profits for the public revenue exceed those of losses. The afore-mentioned symmetry of tax treatment for the upside and the downside of risky investment which is required by theory is only guaranteed if there is full intra-period set off for positive and negative income from different sources, full inter-periodic carry-back and carry-forward of losses and – if there is no taxable profit available for compensation – a true nega-

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23 Supra n.6.
24 For deviations from this general result in case of asymmetric information, limited liability etc. see: K.A.Konrad/W.Richter, Capital Income Taxation and Risk Spreading with Adverse Selection, 28 Canadian Journal of Economics (1995) p.617 et seq.; Buchholz/Konrad supra n.6.
tive income tax\textsuperscript{28}. In an ideal income tax world, this negative income tax would be paid out in real time in order to avoid damaging liquidity effects of risky investment. Therefore, a tax system which denies full compensation of losses (and all existing tax systems restrict loss compensation to a certain extent\textsuperscript{29}) will set an incentive for governments to get their hands on risky investment and at the same time set an incentive for firms to move the risk out of the country to a low-tax jurisdiction where the asymmetric impact of taxation on profits and losses is not as disadvantageous as in the high-tax jurisdiction.

- Secondly, it is hard to distinguish in practice between an infra-marginal profit which stems from the exploitation of a monopolistic asset (i.e. an economic rent) and a profit which simply represents the volatile outcome of risk (like a lottery gain)\textsuperscript{30}. A practical example is the exploitation of an intangible which has been transferred by a R&D unit in a high-tax country to an IP holding company in a low-tax country. Let us assume that the IP holding company has paid a transfer price to the R&D unit which was meant to reflect the market price of this intangible, thus leading to the assumption that the R&D unit has been compensated for any economic rents embodied in this intangible asset at the time of the transfer and that all remaining profits exceeding the marginal rate of return will stem from contingent post-transfer events. Given the fact that there exist major information asymmetries between the multinational enterprise and the involved tax authorities, there will always remain the suspicion that any profit exceeding the marginal rate of return will not be the outcome of a randomized uncertain ex post path but will in fact reflect the rent of an intangible asset that has been transferred without proper consideration ex ante. To put it differently: Behind each transferred “risk” there can always exist some transferred “hidden intangible” whose existence disproves the presumption that risk shifting works in a symmetric fashion.

- The third point is the most difficult one. It refers to the tax effects of “risk premiums”, forming the third element of any business profit. The background is the following: Economic research after Domar and Musgrave applies a so-called von Neumann/Morgenstern utility function analysis to the taxation of risk\textsuperscript{31}. These utility functions presuppose that any risk-averse investor (i.e. an investor who will suffer more from the loss of a given amount of investment than benefit from an identical gain derived from it) will only enter into a risky investment if – in monetary terms - the upside potential of the investment is asymmetrically


\textsuperscript{30} Buchholz/Konrad supra n.6, p.3 et seq.; Feldstein supra n.24, p.756 et seq.; Stiglitz supra n.24, p.264 et seq.


\textsuperscript{32} M.A.Allingham, Risk-Taking and Taxation, 32 Zeitschrift für Nationalökonomie (1972) p.203 et seq., at p.205 et seq.; Buchholz/Konrad supra n.6, p.3 et seq.; Feldstein supra n.24, p.756 et seq.; Stiglitz supra n.24, p.264 et seq.
higher than its downside potential. If we assume that the majority of investors will be rather risk-averse than risk-prone and if we consolidate the outcome of all risky investments made within an economy, the overall upside potential will be higher than the overall downside potential. As the state – via the corporate income tax – participates in all possible outcomes, there will be an extra level of revenue for the state which the State can use either for redistribution or for the creation of public goods or – the simplest option – for handing it back to the taxpayers on a lump sum basis. This outcome looks extremely attractive for the State as this tax seems not to affect investment behavior of private investors: For them, the Domar/Musgrave result still holds: they simply have to increase the size of their investment to end up with the pre-tax situation in the first case.

On the other hand, writers like Konrad and Weisbach doubt the economic value of the risk premium taxed by the state in these cases. They refer to the fact that the state could easily “buy” these risk premiums from private investors in the market for “nothing” as – taking the analogy to capital markets even further - the state acts not only as a “dormant partner” with regard to risky investment but also as an “insurer” benefitting from the fact that it is able to aggregate risk over the whole economy via the corporate income tax. While this is true from the standpoint of an overall equilibrium, the existence of a positive revenue effect cannot be denied. As Stiglitz and Devereux have pointed out, we witness the rare case of a transfer between the private sector and the public sector, where the private actors do not lose economic value while the public sector wins tangible revenue. While this revenue is indeed “worthless” if it is simply handed back to the private actors in whatever fashion, there may come extra value from the production of public goods which private actors would not have initiated on a voluntary basis (given the problems of collective action underlying all sorts of public goods) or from redistribution promoting overall social welfare. Against this background, it makes sense to say that the existence of a “risk premium” reflecting the risk aversion of (most) investors leads to a positive tax revenue for the state in cases of income from risky investment. This is particularly true if risk is idiosyncratic and not sys-

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35 Weisbach supra, n.25, see also Warren supra n.4, p.1 et seq.


38 M.P.Devereux, Taxing Risky Investment, Oxford University Centre for Business Taxation, WP 09/19, p.19.

39 Allingham supra n.30, p.217 et seq.: “Perhaps the best criterion is to consider the government as having a utility function in revenue, and maximizing the expected utility of this – that is acting similarly to individuals. Alternatively this may be interpreted as the government providing a public good with the tax revenue, the individual’s utility function depending on his consumption of both the private good (...) and this public good.”
temic in the sense that major economic shocks might damage the economy as a whole, thus driving business income across the board below the marginal rate of risk-free return. In this case, the “government risk” will then fall on those constituencies who benefit most from the expenditure side of the government.40

To conclude it can be said that there are three reasons for any State to show an interest in the taxation of risky investment:

- The denial of full loss offset, of loss carry back and carry forward and of a negative income tax in the respective tax system.
- The problem of the “hidden intangibles” where infra-marginal profits can as well be the expression of an economic rent as the volatile outcome of a risky activity.
- The “risk premium” charged by risk-averse investors which leads to a statistically higher profit potential than loss potential in case of risky investment.

2. International Situation

a) Taxation of Loss-Making Permanent Establishments

The situation gains an extra twist when we look at the international taxation of risky investment.41 In this context it makes sense to start with a single firm where the investor is located in country A (country of residence) while the investment is made in country B (country of source). This investment is not incorporated itself (as a taxable subsidiary) but is simply a permanent establishment of the taxpayer. At this point we do not take into account any transactions between different independent or affiliated taxpayers. This will be dealt with in chapters III and IV.

Let us start with the question of how the source state treats this situation. Given the above-mentioned features of taxation of risky income the source state will probably benefit from the riskiness of the investment. While the arguments referring to the risk premium and the hidden intangible remain unchanged, the argument referring to the lack of a full tax refund in case of business losses plays even more into the hands of the source state. This is due to the principle of territoriality as will be laid out below.

The state of source is – under international law – entitled to tax the income generated within its territory.42 In the context of risk, this has firstly the effect that the source state will be able to tax profits derived from local investment. On the other hand, the source state will not be obliged to grant a negative income tax if the investment fails. This asymmetry is enlarged by the common rule that the state of source will not be obliged to provide for loss compensation when the taxpayer derives positive income from sources outside its jurisdiction. While this denial might form a disincentive to cross-border investment ex ante, it clear-

41 This section of the article largely follows the analysis by Kane supra n.7, p.873 et seq.
ly works favorable for tax revenue ex post. In the Internal Market of the European Union this disincentive should be regarded an infringement of the freedom of cross-border establishment 43, but in a Luxembourg case the European Court of Justice has ruled in favor of the state of source, taking for granted the limitations of “territorial” taxation 44. This means: the higher the risk of local investment by foreign investors, the higher the possible revenue the state of source may derive from these activities.

The situation is different for the state of residence. This is due to the fact that this state generally taxes the worldwide income of the investor which includes a set-off for losses and profits from different sources in different countries 45. Therefore, the state of residence will both tax foreign-source income from risky investment and grant set-off between foreign losses and domestic profits (or profits from third countries). Insofar, the state of residence shares more of the downside risk of the investment than the state of source. As regards the upside potential of the investment, the taxing right of the state of residence is largely diminished by double taxation conventions which either force the state of residence to give credit for taxes paid in the state of source or to go even further and grant full exemption to the income generated by the permanent establishment set up in the other country. This “asymmetry” regarding the revenue situation of the state or residence - being widely excluded from taxing the profits while widely obliged to grant relief for the losses - has led many countries to decline compensation for losses incurred outside its territory, in particular when they apply the “exemption method” to the respective foreign profits 46. While this policy can be upheld from a fiscal point of view 47, it creates a further disincentive for taxpayers to invest their money abroad: in case the business plan of the foreign investment fails, both the source state and the state of residence might be entitled to deny any deduction of losses 48. This outcome does not only run contrary to the ability-to-pay principle (which claims that losses and expenditure should be deductible once) but also to the claims of international efficiency as it constitutes a tax burden similar in effect to outright double taxation. Nevertheless, the European Court of Justice has accepted the claim of the state of residence that under the “exemption method” both foreign profits and foreign losses can be rendered irrelevant for domestic taxation 49. Only if these losses cannot eventually be recuperated in the country of source (“final losses”) the state or residence is obliged to extend its domestic set of rules for loss compensation to losses incurred in “exempt” permanent establishments.

44 European Court of Justice, Case C-250/95 (Futura Singer), judgment of 15th May 1997 para 18 - 22.
45 Kane supra n.7, p.878 et seq.
46 It is highly disputed whether the “exemption method” laid down in DTCs has to be construed as leading to exclusion of foreign profit from offset with domestic profits (see: E.Reimer in: E.Reimer/N.Urban/S.Schmid (Ed.), Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty, and OECD Perspective, 2011, para 212).
47 Kane supra n.7, p.902 et seq.
49 European Court of Justice, Case C-414/06 (Lidl Belgium) judgment of 15th May 2008 para 27 - 53.
Again, both the state of residence and the state of source have an interest to tax income from risky investment. The only difference lies in the fact that the state of residence might be obliged under domestic or supranational law to grant additional relief for foreign losses as compared to the state of source. Nevertheless, all the limitations of domestic loss-offset and carry forward/carry back apply in the international context as well. Moreover, taxation of risk premiums and “hidden intangibles” might also contribute to an interest of both involved states to get hold of the taxing right with regard to the investment in the first place.

b) Taxation of Loss-Making Subsidiaries

The situation is slightly but not fundamentally different if the foreign investment is made by setting-up a local subsidiary which is a local taxpayer in its own right. From the point of view of the source state, the situation remains beneficial as it will be entitled to tax the profits derived by this subsidiary while any losses exceeding profits available for set-off will simply be disregarded. Moreover, any losses or profits derived by the parent company or other affiliated group members have no relevance for the taxation of the local subsidiary.

As far as the state of residence of the investor (an individual shareholder or a parent company) is concerned, any profit derived by the subsidiary and later paid out as a dividend will be taxable in the state of residence depending on whether domestic tax law provides for full taxation (U.S.), shareholder relief (Germany for individual shareholders) or full exemption (Germany for “substantial” corporate shareholders) of foreign dividends. As foreign losses cannot be “distributed” to the shareholder, there is no immediate impact of a loss incurred at the level of the subsidiary on the tax situation of the parent company. Nevertheless, there might be an indirect effect if those losses affect the value of the participation, thus leading to a capital loss. Again, countries have embarked on different paths with regard to these losses. While in Germany there exist harsh restrictions on the compensation of capital losses from shares, in the U.S. the principle of worldwide taxation leads to recognition of these losses. Irrespective of the details, the state of source again is the “winner” when it comes to the tax effects of risky investment on its territory.

III. International Taxation with Independent Enterprises

1. Risk and the Concept of Income

The current international tax system is built on the assumption that the taxation of intra-group activities is modeled on the taxation of independent enterprises. This is due to two complementary rules: Firstly, the allocation rules on cross-border income (income from sales and services, income from permanent establishments, interest and royalties) laid down in the OECD Model DTC do not distinguish between cases where the trading partner is an affiliated entity or an independent “third party”. There are no special allocation rules for intra-group interest, intra-group royalties, intra-group service compensation and the like. Secondly, the conditions of intra-group contractual relations are submitted to the arm’s-length test

50 Schön supra n.5, p.230 et seq.
under Art.9 OECD Model which is meant to provide for a level playing field between independent and affiliated enterprises. Against this background, it makes sense to take a look at the tax treatment of risk allocation between independent enterprises before one can make a meaningful statement on the deliberations by the OECD to restrict the discretion of group companies to allocate risk among them in a tax-relevant fashion.

The starting point of the game is the fact that independent enterprises are taxed with regard to their separate income. This means in the first place that income taxation takes an ex post view: Once the risk has crystallized, the winner is taxed on her gains and the loser incurs a loss and may have the option of a set-off with other positive income. Unlike a tax on net wealth or a tax on a notional return on investment, current income taxation follows the outcome of a random path. Neither the taxpayers nor the state know in advance which of the involved parties will bear which tax burden ex post.

Individual income is the economic result of the contractual arrangements entered into by the parties, i.e. the sum of the items of revenue and items of expenditure incurred by these parties when they perform their duties under the relevant contracts. Insofar, income taxation in principle accepts risk allocation between independent parties. To give an example: When a manufacturing company negotiates a distribution agreement with an independent retail company, they can arrange for the allocation of the market risk in multiple ways: The manufacturing company can sell a fixed bulk of goods to the sales company, thus pushing market risk fully to the sales company. They can enter into a contract under which the sales company receives a fixed consideration for services, thus leaving market risk at the level of the manufacturer. They can also go for intermediate solutions like a commissionaire agreement where both contractors win and lose in a proportionate fashion from the successful penetration of the market (as the commissionaire will receive a percentage of the proceeds from the sales as a “commission”). Similar arrangements can be made with regard to research and development (this is largely the case when multinational IT firms outsource software development to small outfits) and with regard to manufacturing itself (e.g. when toll or contract manufacturing in developing countries is at stake). Again, contractual cost sharing leads to a proportional participation in the upside and downside on an activity. This principle: “tax follows income, income follows risk”, is not only fully compatible with the traditional SHS-concept of income but also with the Domar/Musgrave result that a linear tax on risky investment incentivizes this sort of investment in a socially beneficial fashion.

2. Personal and Territorial Allocation of Income

The major effect of applying the SHS concept of income to the taxation of risky investment lies in the fact that for each of the involved taxpayers, the respective rules of national and

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52 This is not the case if both investors and the state constantly adjust their portfolios (L.Kaplow, Taxation and Risk Taking: A General Equilibrium Perspective, 47 National Tax Journal (1994) p.789 et seq., at p.793). Moreover, some elements of the tax base may support an ex ante view (Bulow/Summers supra n.33, p.25 on pre-determined depreciation deductions).
53 Bullen supra n.7, p.486 et seq.
international law apply. If the manufacturing company is located in state A and the distributing company in state B, each of the two parties will be taxed according to the rules of its state of residence. Insofar, the personal allocation of income to one of the contractors transforms into a territorial allocation of the respective taxing right to the country of residence.

It is fairly often overlooked that the personal allocation of income is only the first of two steps which lead to the final allocation of taxing rights between the involved jurisdictions. At the second level one has to determine whether the taxpayer who is not resident in a given country is nevertheless liable to tax with respect to the territorially defined income in the source state. It is up to the involved countries to agree on an allocation of taxing rights with respect to source which supersedes the foregoing personal allocation of income and thus also the contractual allocation of taxing rights.

The manufacturer-distributor situation is a case in point. If the parties have agreed that the full upside and downside of the market risk shall be borne by the (foreign) manufacturer and if the investment turns out to be highly profitable, this leads to a large-scale allocation of profit to the manufacturer. On the other hand, this is still income sourced in the country where the distribution takes place and the market is exploited. At this level we have to assert whether the source state is in the position to tax the foreign manufacturer on domestic income. Given the current treaty situation which largely excludes inbound sales and services from source taxation, this is not the case. Only if the manufacturer maintains a permanent establishment in the state of source (and only insofar as profits can be attributed to this permanent establishment) is the country of source in the position to claw back tax revenue from the profits derived from successful market transactions.

This is the background for the ongoing debate of the scope of the definition of a permanent establishment under Art.5 OECD Model and in particular of Art.5 par.5 OECD Model on the “dependent agent” concept which has been widely discussed for “commissionaire” cases and similar arrangements. The allocation of market risk to the foreign producer under a commissionaire arrangement can only be counteracted by the state of source if they succeed in showing that the commissionaire is nothing more than a dependent agent of the foreign principal. An extension of source taxation to income from inbound sales and services would render the contractual risk allocation between foreign principal and domestic agent largely irrelevant for tax purposes. Another case in point is (captive) insurance companies. Risk allocation to an affiliated insurance company in a low-tax jurisdiction has a palpable tax effect because the profit from services rendered by this insurance company to other group members is under international tax law only taxed in its country of residence. Once international tax rules are rewritten, introducing taxation of profits from insurance services where...

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the insured person or the insured assets are located on a source basis, the international “risk problem” would simply go away.

To be sure, the introduction of source taxation on inbound sales and services would not only lead to a special rule of non-recognition vis-à-vis contractual risk arrangements. Such a change in the allocation rules would go far beyond the particular case of intra-group transactions and it would not react to risk shifting as such but to international income from sales and services and general. It is quite clear that this would be a large move away from the current model and have repercussions far beyond the cases where risk allocation plays a pivotal role. This leads us to the conclusion that one might first have a look at the specific features of risk allocation within corporate groups and its effects on the personal and territorial allocation of income before one establishes new allocation rules for income from sales and services in general.

IV. International Taxation with Affiliated Enterprises

1. Personal vs. Territorial Allocation of Income

In the preceding chapter it has been said that with respect to independent enterprises the allocation of tax revenue to the involved jurisdictions follows a two-tier approach: In the first place one has to ascertain the amount of income attributable to the involved persons; at the second level one has to agree on taxing rights for governments on the basis of source and residence. From an analytical point of view, this approach should be applied to affiliated enterprises as well.

Insofar, the application of the arm’s length standard under Art.9 OECD Model has the effect of allocating income from risky activities on a separate basis to the involved members of the multinational group. But one should not simply assume that the result is the final word on the allocation of taxing rights. Rather, the result of transfer pricing analysis is only the starting point for further policy considerations on a fair and efficient taxation by the involved states.

To give an example for this distinction: The BEPS work by OECD on international taxation starts from the assumption that the allocation of taxing rights should refrain from giving too much weight to contractual rights and obligations and shift towards the location of “real activities”\(^{56}\). This claim reaches beyond a sophistication of the current transfer pricing discipline as the whole concept of the arm’s length standard takes contractual rights and obligations as the logical starting point for the allocation of taxing rights. Taxation on the basis of “real activities” is a concept that does not logically embrace the arm’s length standard but rather refers to some “objective” allocation of taxing rights irrespective of which group member “earns” the profits from a certain activity. It shows features of formulary apportionment insofar as it refers to the existence of “people” and “equipment” in specific loca-

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\(^{56}\) OECD, Addressing Base Erosion and Profit Shifting, 2013, p.51: “The main purpose of that plan would be to provide countries with instruments, domestic and international, aiming at better aligning rights to tax with real economic activity”; OECD, Action Plan, 2013, p.10.
tions. In the following two sub-chapters this distinction is paramount: We shall firstly see how far the arm’s length standard can go with respect to risk allocation and then discuss the remaining leeway for governments to agree on a modified allocation of taxing rights for risky intra-group income.

2. Personal Allocation: The Arm’s Length Standard and Income from Risky Investment

a) Independent Activities within a Multinational Firm

The first dimension of the problem which has to be understood in this context stems from the fact that risk allocation within a multinational firm does not necessarily derive from contractual arrangements between members of the firm. Risk allocation within a group starts when different business activities (having different risk profiles) are allocated to separate members of the firm. To give an example: A German bank is mostly active in retail banking, delivering routine services and handing out plain vanilla loans to individual clients. It has set up a subsidiary in the City of London which specializes in high-risk investment banking. There are no contractual relations between these affiliated companies which could and would be subject to “adjustments” (and we assume that there are not even indirect relations like an implicit guarantee or economically relevant headquarter activities).

Transfer pricing analysis would simply not affect this situation as there are no “conditions” which can be “adjusted”: the German company would be taxed on its low-risk income by the German tax authorities while the UK Company would be taxed on its high-risk income by HMRC. The Transfer Pricing Guidelines accept this situation. But there are limits: A company which carries on a loss-making activity in order to fill a gap in the overall market presence of the group as such may require compensation from other group members for this indirect contribution to their profits.

It deserves mentioning at this point that any “formulary” approach to the taxation of multinational enterprises would indeed disregard the different risk profiles of the involved members of the group. Any formula factor like “sales”, “capital” or “workforce/payroll” would in principle leave out the more or less risky nature of the underlying business. While it may be true that some of these factors seem to have remote proxy qualities with respect to risk (capital serving as a proxy for “risk buffer”; payroll serving as a proxy for high-quality employees “managing risk”) formulary apportionment would basically level out the individual risk profiles of the involved taxpayers and activities.

b) Contractual Risk Allocation

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58 OECD Transfer Pricing Guidelines 2010 para 1.70 et seq.
aa) Parity with Independent Taxpayers

Transfer pricing control sets in when group members enter into contractual relations with each other. There are well known cases for risk shifting within a group; we have named some of them in a preceding chapter (captive insurance; contract manufacturing and contract research; commissaire agreements). OECD has dealt with these instruments in three places: in the general part of its 2010 Transfer Pricing Guidelines\(^{59}\), in the novel chapter of these Guidelines on “Business Restructurings”\(^{60}\), and in the current Discussion Draft on “Special Considerations for Intangibles”\(^{61}\).

Given the fact that independent firms can contractually shift risk between them in a fashion that is recognized by the tax authorities, the Transfer Pricing Guidelines also accept and respect the contractual relations between members of a multinational group as this provides parity between independent taxpayers and taxpayers which are members of a multinational group\(^{62}\). Moreover, “the mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm’s length”\(^{63}\).

On the other hand, equal treatment of affiliated and independent taxpayers is also the starting point for transfer pricing adjustments under the arm’s length standard: If and insofar as conditions for intra-group risk allocation deviate from those hypothetically agreed between independent firms, Art.9 OECD Model empowers tax authorities to adjust these conditions to the extent necessary to ensure third party treatment. The arm’s length standard provides therefore both the foundation for the recognition of contractual risk allocation and the limitations to the contractual freedom of the affiliated companies\(^{64}\). As independent parties weighing their options would regard the “level of risk” to be economically relevant\(^{65}\), so should affiliated companies do.

bb) Compensation for Risk

The first and foremost element of transfer pricing analysis as to risk concerns the adequate compensation for any group member assuming risk\(^{66}\). It is generally accepted that no independent firm would assume additional substantial risk without seeking compensation for the downside potential of this activity.

Basically, there are two modes of compensation one can think of:

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\(^{59}\) OECD, Transfer Pricing Guidelines, 2010, Chapter I.

\(^{60}\) OECD, Transfer Pricing Guidelines, 2010, Chapter IX.

\(^{61}\) OECD, Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, 30 July 2013, para 35 et seq.

\(^{62}\) OECD Transfer Pricing Guidelines 2010 para 1.8, 9.11; D.Ernick supra n.56, p.681.

\(^{63}\) OECD Transfer Pricing Guidelines 2010 para 1.11, 9.19, 9.36.


\(^{65}\) OECD Transfer Pricing Guidelines 2010 para 1.34, 1.36, 1.42.

\(^{66}\) OECD Transfer Pricing Guidelines 2010 para 1.45 et seq., 2.31, 2.36, 2.54, 2.86, 9.10 et seq., 9.39 et seq.; OECD Discussion Draft on Transfer Pricing Aspects of Intangibles, 30 July 2013 para 88; Wittendorff supra n.63, p.403 et seq.
- Firstly, there should be symmetry with regard to expected expenditure and expected returns. Insofar as a group member takes risk by incurring costs (including contingent liabilities), this downside has to be compensated by an increased proportional participation in the profit potential. A case in point is the role of a distributor who invests substantially in market penetration (e.g. by financing a huge marketing campaign) and should therefore receive a higher share in the proceeds of sales than a distributor who only administers the delivery of goods to consumers\textsuperscript{67}. Similar arguments can be made for the profit participation of a R&D unit or a manufacturing subsidiary. The assumption of additional risk justifies the claim to additional profit potential\textsuperscript{68}. This is a clear test case for the arm’s length standard.

- A special case to test the correlation between benefits and costs including risk is the Cost Contribution Arrangement (CCA) when several parties join forces to achieve a common aim. Here we need a fair allocation of expected benefits on the basis of relative contributions including the assumption of risk\textsuperscript{69}.

- Another way of compensating for the assumption of risk is a fixed additional fee which reflects the negative value of the additional risk. The most prominent example is the payment of an “insurance premium” by one group member to the other, in particular where independent parties might enter into similar contractual arrangements with outside insurers.

It cannot be stressed enough that the valuation of the upside and the downside potential of expected benefits and losses which contribute to the “net present value” of the overall investment is of utmost importance for the convincing execution of the transfer pricing analysis. Though it is evident that it is extremely hard to nail down specific probabilities for specific outcomes\textsuperscript{70} one should always bear in mind that this is where “risk shifting” clearly ends up in “profit shifting”: either because profits are relocated without relocating the full downside as well or because tangible or intangible assets are transferred to other group members, thus disguising rents as risky income\textsuperscript{71}. This includes cases where risk is allocated after its outcome is known or reasonably knowable\textsuperscript{72}. One can fairly assume that a large part of profit shifting via risk shifting can be dismantled by a clear analysis of these elements.

cc) Capacity to bear Risk

Another element which the Transfer Pricing Guidelines have addressed concerning risk lies in the statement that any contractual risk allocation under the arm’s length standard would have to assess the risk-bearing capacity of the party assuming the risk\textsuperscript{73}. Nobody would en-

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\textsuperscript{67} OECD, Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, 30 July 2013, para 237 et seq.
\textsuperscript{68} OECD Transfer Pricing Guidelines 2010 para 1.47, 1.62.
\textsuperscript{69} OECD Transfer Pricing Guidelines 2010 para 8.8 et seq.
\textsuperscript{71} See below d).
\textsuperscript{72} Bullen supra n.7, p.379 et seq.
\textsuperscript{73} Bullen supra n.7, p.383 et seq.; Wittendorff supra n.63, p.407 et seq.
enter into an insurance contract with another party and pay insurance premiums to that other
party unless the insurer disposes of financial means which are likely to cover the damage
once the insured event actually happens. Nobody would hedge currency risk with a party
which is likely to go insolvent once the currency risk crystallizes.

This insight is not only relevant from a transfer pricing point of view regarding the allocation
of profits between group members but also with respect to tax allocation between coun-
dries. The reason is the following: If the counterparty is not capable to bear the risk allocated
to it, this risk will inevitably fall back on the insured person, thus creating a tax-relevant loss
for this taxpayer. Against this background, the allocation of risk to a party which is not able
to bear the risk will end up in an asymmetric allocation of the upside potential to this coun-
terparty (e.g. from earning insurance premiums in a low-tax jurisdiction) while the downside
potential will simply stay where it is (with the insured person in the high tax jurisdiction).
This method of asymmetric risk allocation is exactly not what international tax law should
accept.

dd) Control of Risk

Another concept to which the Transfer Pricing Guidelines attach much weight to is the no-
tion of “control”\(^\text{74}\). It is assumed by the Guidelines that no party will be prepared to assume
risk if it is not in the position to “control” the risk to a limited extent. From this starting point
the Discussion Draft on Intangibles concludes that income cannot be simply allocated on the
basis of “ownership” or “funding” or income-generating assets\(^\text{75}\). It is required that a sub-
stantial number of people take “control” of the asset, its creation and its administration. A
major example is R&D the proceeds of which shall only be attributed to an IP holding com-
pany (in a low-tax jurisdiction) if the IP holding company features a sufficiently large group of
employees to take care of the assets\(^\text{76}\).

\(^{74}\) OECD Transfer Pricing Guidelines 2010 para 1.49, 9.20 et seq., 9.22 et seq.; Bullen supra n.7, p.391 et seq.;
M.Sullivan, Example 13 of the OECD Revised Intangibles Draft, Tax Notes, 26th August 2013, p.858 et seq.
\(^{75}\) OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, 30 July 2013 para 73;
L.Helderman/ E.Sporken/R.Okten/M.Kanter, A New Era in Determining Arm’s Length Compensation for Intangibles: A Comparative Overview of Existing and Possible Future Transfer Pricing Principles, 20 International Trans-
fer Pricing Journal (2013) p.359 et seq.; S.Pantelidaki/R.Thomas, Impact of OECD intangibles developments in finan-
cial services, Transfer Pricing International Journal, Issue 11/2013, p.4 et seq.;
C.Silbersztein/M.C.Bennett/G.D.Lemein, The OECD Discussion Draft on the Transfer of Intangibles (Revision of
Chapter VI of the OECD Transfer Pricing Guidelines) – Detailed Comments, 41 Intertax (2013) p.66 et seq., at
p.71 et seq.; for a more nuanced view of the recent discussion draft see: J.Wittendorff, OECD Revised Discus-
sion Draft on Intangibles – A Step in the Right Direction, Tax Notes International, 30th September 2013, p.1325
et seq., at 1330 et seq.
\(^{76}\) OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, 30 July 2013 para 76 et seq.: “If the
legal owner of intangibles is to be entitled ultimately to retain the returns attributable to the intangibles, it will
either perform the functions related to development, enhancement, maintenance and protection of the intan-
gibles, or arrange to have such functions performed under its control by independent enterprises or by associ-
ated enterprises”. S.Huibregtse/M.Peeters/L.Verdonker/S.Carey, IP Companies and Substance: No-Fly Zones?, 12
Transfer Pricing International Journal, Issue 5/2011, p.4 et seq.; critics of the arm’s length condition regard the
notion of “control” to be insufficient for a fair allocation of the residual (M.C.Durst, The OECD’s Discussion Draft
on Transfer Pricing for Intangibles, Tax Notes International, 30th July 2012, p.447 et seq., at p.449 et seq.
While it is clear that there are some categories of risk which cannot be controlled by either of the involved parties (currency risk, political risk, inflation risk etc.), there exist other risks where one party seems to be better positioned than the other to administer the risk, i.e. to take protective action if necessary, to minimize existing damages and so on. Using the terminology of “law and economics”, it can be said that the party who is “closer” to the risk is the “least cost-avoider” and should therefore ultimately bear the risk. An arm’s length argument might run as follows: The party which is not able to control the risk would have to seek a compensation for assuming the risk which would be higher than the respective cost incurred by the other party – the “least cost-avoider” - in the first place. Against this background, one might come to the conclusion that the cheaper cost-avoider will not rationally enter into such an agreement77.

Nevertheless, this argument does not stand close scrutiny78. Rather, it would be wrong to assume that “control” can play a major role when it comes to the application of transfer pricing discipline in a multinational group. Firstly, the theory of the “least cost-avoider” has been developed in the context of tort law, not in the area of contract law79. Under tort law it makes sense to set incentives for lowering risk and reducing damages by allocating liabilities under civil law to the person who is best equipped to administer the risk in the first place. But this proposition does not necessarily translate into contract law. To the contrary, a great deal of contractual instruments between independent parties is meant to shift risk away from the person closest to the risk in order to reach efficiency. One major case is insurance: while it is evident that the insured person is much closer to the risk and controls it in many cases to a limited extent (car insurance, health insurance) the economic benefit of diversification has led to the establishment of insurance companies all over the world who hardly control any risk they insure80. Another case is the rise of the corporation as such: the shareholder contributes capital and bears the upside and downside risk of its use but has shifted control to a large extent to the management. This is due to the economic benefits of “division of labor” which support the existence of “agency relationships” all over the place81.

Thus, the notion of “control” should not have a central place in this analysis. It should rather be limited to those safeguards which are regularly established between independent parties, whenever “risk” and “management” diverge to a certain extent. These safeguards refer largely to problems of moral hazard and other opportunistic behavior. An insurance company will not be prepared to compensate damages willfully caused by the insured person. A shareholder will not accept any private diversion of assets or other modes of self-dealing like the capturing of corporate opportunities by the management. Moreover, every agency relationship will involve a limited obligation of the agent to report to the principal on the state of affairs and the principal will be in the position to terminate the agency relationship in due

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77 Bullen supra n.7, p.394 et seq.
course. Similar safeguards will be agreed between a client and any service provider or in the context of a trust relationship. But this protective contractual framework should not be mixed up with a far-reaching and fuzzy notion of “control” in the sense of superior steering capacity on the side of the principal82. Neither the shareholder vis-à-vis the manager nor the insurer vis-à-vis the insured person exert any substantial influence on the way those people manage their affairs.

In the context of transfer pricing control, we have to recognize the fact that the work of the OECD is gradually beffing up the substance of control required for the assumption of risk83. This refers to arrangements where high-level research units, manufacturing units or distribution units have agreed to perform their duties on behalf of an affiliated entity in a low-tax jurisdiction which funds the activity and bears the risk but hardly exercises any meaningful supervisory functions with regard to the performance of the local contractors. In particular, OECD seems to assume that any principal assuming risk must be well equipped to monitor the quality of the work done by the agent (e. g. by an extensive management force allocated to the principal84) and to make major decisions from time to time85. This is not true. In most cases, independent parties hire service providers simply because they trust them and rely on contractual and legal remedies if they fail to deliver. Nobody would hire a doctor, a lawyer or an architect if he were supposed to possess superior knowledge enabling him to “control” the activities of the agent. Against this background it seems that the notion of “control” is dangerous and misleading insofar as it goes beyond the basic contractual limitations for opportunistic behavior of agents. The arm’s length standard does not require full and substantial control of the agent’s activities.

ee) “Significant People Functions” and Risk

The notion of “control” exercised by real people being a relevant criterion for the allocation of risk within a multinational firm according to recent OECD work bears meaningful similarities to the concept of “significant people functions” employed by the OECD Report on “Profit Allocation for Permanent Establishments” released in 2008. For the purpose of dividing in-

84 Helderman et al. n.74, p.364.
85 OECD Transfer Pricing Guidelines 2010 para 9.23 et seq.: “In the context of paragraph 1.49, “control” should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people — employees or directors — who have the authority to, and effectively do, perform these control functions.”
come from risky activities between the head office and the permanent establishment of a single firm this report starts from the hypothesis that risk shall be allocated to the territory where it is “assumed”, i.e. where people perform the function of deciding on whether a risk is to be taken or not:

“(…) the authorized OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risk are performed by people in the PE (…)”86. “The significant people functions relevant to the assumption of risks are those which require active decision-making with regard to the acceptance and/or management (subsequent to the transfer) or those risks. The extent of the decision-making will depend on the nature of the risk involved”87.

This approach puts a lot of weight on the physical presence of persons and their role within the organizational framework of a firm. In particular the locus of decisions made by “key entrepreneurial” people brings forward a semi-territorial aspect which is by no means related to the contractual relationships within multinational firms (or towards independent parties).

Contrary to this, there are many reasons for not overstating the role of “people” when it comes to risk allocation under transfer pricing rules within a multinational group:

- First of all, one should not forget that the relevance of “key entrepreneurial risk-takers” came up in the preparatory stages of the 2008 report when profit allocation for banks and other financial institutions was discussed where value creation is highly related to the know-how and market activities of individual dealers and other managers88. Their day-to-day trading decisions clearly influence the success of the company. Such “decision making” is not that relevant in other sectors of the economy like production, research & development or services. Even in the PE context it is not a passepartout for risk allocation in general89.

- Moreover, the 2008 Report had to start from the fact that the division of profits between the head office and the permanent establishment cannot build on the separation of entities under private law and intra-group contractual agreements which are the baseline for the taxation of multinationals under the arm’s length standard. The Report states that income allocation follows a different theory for separate companies:

“The factual, legal position in a PE context, on the other hand, is that there is no single part of an enterprise which legally “owns” the assets, assumes the risks, possesses the capital or contracts with separate enterprises. (...) It is therefore necessary (...)”

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86 OECD, Report on the Attribution of Profits to Permanent Establishments, 2008, para 18 s.3.
88 OECD, Report on the Attribution of Profits to Permanent Establishments, 2008, Part II: Special Considerations for Applying the Authorized OECD Approach to Permanent Establishments (PEs) of Banks.
to develop a mechanism for attributing risks, economic ownership of assets and capital to the hypothetically distinct and separate PE (…)\textsuperscript{90}.

Therefore, one cannot simply transplant notions of “people functions” from the PE context to transfer pricing discipline as applied to distinct legal entities.

- The most important argument against profit allocation based on the physical presence of people performing “significant functions” lies in the fact that these people who decide on the assumption of risk do not bear these risks themselves. Therefore, any income allocation on the basis of decision-making people leads to arbitrary results. The ultimate risk-bearers in a corporation are always the shareholders of the company. They might be resident anywhere in the world. Against the background that the shareholders enjoy the benefits of limited liability it makes sense to allocate risk at an intermediate level, i.e. to refer to the company’s assets which can be seized by creditors when financial risk crystallizes or which are subject to devaluation or obsolescence, thus contributing to tax losses. In a single company, all assets are owned by this entity and all risks are allocated to that entity. Within a multinational group, “asset partitioning”\textsuperscript{91} via separation of legal entities essentially leads to an allocation of risk to those legal entities which have assumed certain risk under contractual agreements within the multinational group and towards outside parties so that assets owned by these companies are liable for these risks. This is particularly important if group companies have creditors of their own and/or minority shareholders of their own. Against this background, notions of “ownership”, “funding” and “contract” under private law rightfully play a substantial role as they are the cornerstone of income allocation in a broader sense.

We can perceive the underlying tension between “ownership”, “funding” and “contracts” on the one hand and “real activity” on the other hand when we ask ourselves to what extent income that is clearly allocable to a given entity (resident in a low tax jurisdiction) from a private law point of view shall be taxable only in the country of residence once all value-driving contributions from other entities have been remunerated at arm’s length. We come to the conclusion that (unless we go for formulary apportionment) “ownership”, “funding” and “contractual risk allocation” under private law remain the most relevant factors as they delineate the economic outcome of risky activities for the involved entities. Notions of “decision-making, “control” or “activity” are of secondary importance for the allocation of this residual profit.

c) Risk Premiums within the Multinational Firm?

While there is no reason to doubt the relevance of contractual risk allocation under the arm’s length standard in general, there is a reason to take a closer look at the notion of “risk premium” in the context of intra-group trade. It has been laid out above that investors

\textsuperscript{90} OECD, Report on the Attribution of Profits to Permanent Establishments, 2008, para 17, 97 et seq.

\textsuperscript{91} Kraakman et al. supra n.80, p.9 et seq.
charge a “risk premium” on their investment if they are risk-averse, thus expecting a higher positive outcome in case of success as compared to the loss they suffer in case of failure. This risk premium can be taxed by the state; moreover, in a cross-border situation the existence of risk premiums will generate an interest for the involved tax authorities in taxing “risky income”, expecting fiscal revenue generated by the risk premiums.

Yet, when contractual risk allocation within a domestic or multinational group is at stake, one may wonder whether it makes sense at all to recognize the allocation of risk premiums to individual group members. In this respect we have to distinguish between transactions purely shifting risks between group members and arrangements concerning the assumption of risks towards third parties.

Economically speaking, the existence and the size of a risk premium are highly connected to the utility function of the respective investor. In a group situation where a parent company and a host of wholly-owned subsidiaries enter into contractual agreements with each other, both the upside and the downside of any investment will ultimately be borne by the shareholders of the parent company. Insofar, there is no justification for charging a risk premium between the respective group companies. This should lead to the conclusion that while contractual risk allocation within a group can be arranged, this should end up in a fully symmetric allocation of upside and downside potential leaving aside any risk premiums. The internal excess profits derived from a risk premium which transform “risk shifting” into “profit shifting” should not be accepted from the point of view of international taxation.

A case in point are captive insurance companies: The captive insurance unit (in a low tax jurisdiction) should not be in the position to charge a “risk premium” towards its sister unit (in a high tax jurisdiction). The insurance fee should only be based on the size of the insured loss or damage and the probability of its crystallization. The assumption of risk will then not lead to an assumption of profit. From an analytical point of view this is one of the cases where the traditional application of the arm’s length standard leads the wrong way. While independent taxpayers (individuals or corporations owned by different groups of shareholders) show separate risk profiles which justify charging a risk premium, this does not hold true for corporate taxpayers owned by the same group of individuals. These individuals will not insist on a risk premium whenever group members interact with each other. Insofar, risk premiums charged by captive insurance companies should be disregarded by the tax authorities. This again will lead to a reduction of the leeway for multinational companies to use contractual risk allocation for profit-shifting purposes.

While this analysis looks good for the transactional allocation of risk between group members like captive insurance or intragroup debt, the same is not self-evident when it comes to the allocation of business functions involving certain risk profiles towards third parties. A

C.Roberge (Transfer Pricing in the Pharmaceutical Industry: The Remuneration of Marketing Intangibles, 20 International Transfer Pricing Journal (2013) p.212 et seq., at 220 et seq.) distinguishes between transactional risk (who bears the costs of an investment) and functional risk (who is affected by the potential of a function for profit or failure).
case in point is market risk, i.e. the risk that goods and services produced inside the group do not find customers on the demand side of the market. For the comprehensive activity of producing and selling goods in the market, the multinational group (and their shareholders) is entitled to charge a risk premium towards third parties. The group as such will not invest into production and distribution unless the upside potential exceeds the downside potential. This leads to the question whether the resulting risk premium for the overall activity can contractually be attributed to the manufacturing subsidiary and/or to the distributing subsidiary at arm’s length.

Taking a closer look the answer is twofold.

- In the first place, the response is in the affirmative. If it is true that different legal entities within the multinational group can be allocated different risk profiles (e.g. retail bank vs. investment bank) and if it is true that legal entities within a multinational group may enter into different types of contractual arrangement for economically connected functions, it is possible to shift “market risk” and its returns either to the production unit or to the distribution unit.

- Secondly, there are limits to this kind of risk allocation. If both the production unit and the distribution unit belong to the same “value chain”, the economic success of one unit and the utility of its investment depend on the economic success of the other unit. If we shift “market risk” to the distribution unit and if the production unit has only one customer – the distribution unit – it becomes clear that factually the production unit will also be hit by a failure of its products in the open market. The production unit will therefore charge an extra premium for the risk that its only customer (the distribution unit) will go out of business or drastically reduce its demand in this product line. Any “cost plus” arrangement between the production unit and the distribution unit will have to reflect this underlying risk, thus spreading the proceeds more evenly among the involved business entities. It goes without saying that the same logic applies if the market risk is initially borne by the production unit and the distribution unit is reduced to a mere service provider.

**d) Information Constraints and “Hidden Intangibles”?**

The third element which contributes largely to the perception that “risk-shifting” results in “profit shifting” is related to the afore-mentioned problem of the “hidden intangible” which can be transferred at no or low consideration to another company within the group in the context of a contractual allocation of risk. The most relevant example is the transfer of an

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93 See above IV.2.a).
intermediate R&D product to a sister company located in a tax haven\textsuperscript{94}. The same is true for CCAs involving “buy-in” payments from parties entering a venture midstream\textsuperscript{95}.

While it is clear that this sale is subject to transfer pricing discipline exercised under the arm’s length standard, it is also evident that there is huge leeway for under-valuation, given the lack of information (on the side of the tax authorities but in many cases also on the side of the involved private actors) as to the true value of the intermediate product\textsuperscript{96}. But traditional transfer pricing analysis takes an \textit{ex ante} approach\textsuperscript{97}. If the product turns out to be more successful than anticipated when it was evaluated at the time of the transfer, this might trigger the wish for \textit{ex post} claims by the tax authorities at the transferor’s end. But it is always unclear whether the eventual infra-marginal profits represent a “rent” on a “hidden intangible” transferred in a disguised fashion or whether they represent the outcome of randomized post-transfer events\textsuperscript{98}. There are similar questions when a “business restructuring” is not only meant to re-arrange risk allocation within the group but also involves the transfer of something valuable between the members of the group\textsuperscript{99}.

This leads to the question whether the transfer of an intangible should be tested in a different fashion when compared to the standard approach of the arm’s length test. Insofar, we have to take into account that the arm’s length test tries to apply an \textit{ex ante} test to the transfer of the intangible on the basis of insufficient information; the \textit{ex post} outcome might hugely differ from the anticipated valuation. This has induced some tax authorities to establish additional \textit{ex post} controls like the “commensurate with income” standard in the United States\textsuperscript{100} or the legal presumption favoring later adjustments to contractual agreements under German rules on “transfer of functions”\textsuperscript{101}. These provisions hypothesize, that independent parties would not have agreed on a lump sum payment for the transferred intangible but rather had negotiated follow-up adjustment clauses in any case which would make

\begin{itemize}
  \item \textsuperscript{94} OECD, Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, 30 July 2013, para 224 et seq. (Example 1); H.v.d.Hurk, \textit{Starbucks versus the People}, 68 Bulletin for International Taxation (2014) p.27 et seq., at p.29; G.Kofer supra n.21, p.649 et seq.
  \item \textsuperscript{96} M.Boos, \textit{International Transfer Pricing: The Valuation of Intangible Assets}, 2003, p.218 et seq.
  \item \textsuperscript{97} Wittendorff supra n.63, p.377; M.Erasmus-Koen, ?, in: A.Bakker (Ed.), \textit{Transfer Pricing and Business Restructuring: Streamlining all the Way}, 2009, p.99 et seq., at 139 et seq.
  \item \textsuperscript{98} See: OECD, Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, 30 July 2013, para 146, for risks related to the transfer or intangibles, and para 169 on profit splits regarding “partially developed intangibles”.
  \item \textsuperscript{99} OECD Transfer Pricing Guidelines 2010 para 9.65, 9.71, 9.87.
  \item \textsuperscript{101} Sec.1 Außensteuerasetz (Foreign Tax Act); see K.E.M.Beck, \textit{Business Restructuring in Germany}, 51 Tax Notes International, 21\textsuperscript{st} July 2008, p.271 et seq., at p.276 et seq.; 278 et seq.
\end{itemize}
the consideration paid for the intangible dependent on later events (e. g. the successful exploitation of a patent or a trademark)\textsuperscript{102}.

These \textit{ex post} tests have been largely criticized insofar as they purport to reflect the normal application of the arm’s length standard. It is said that one should not pretend that the \textit{ex post} taxation of fictitious royalties and similar emoluments by Germany and the United States can be justified in the context of the arm’s length paradigm. Rather, there seems to be a situation where even third parties might be willing to transfer intangibles and similar entitlements for a fixed consideration, thus shifting the risk of success fully to the transferee of the underlying IP right.

Taking a closer look it becomes clear that the arm’s length standard is simply not reliable enough to deal with these intra-group arrangements from a tax policy point of view. As it is not possible for the involved tax authorities to truly overcome the information asymmetry between the multinational enterprise and the government (and maybe even within the multinational enterprise itself) with respect to “hidden intangibles” it makes sense for governments to simply allocate taxing rights with respect to the \textit{ex post} revenue generated by the intangible, thus securing a tax claim on real income. Similar \textit{ex post} tax rules should be applied with respect to the transfer of a customer base, the transfer of brands and other marketing intangibles or with respect to organizational intangibles.

From the perspective of international risk allocation, such an \textit{ex post} approach limits at the same time the leeway for undervalued transfers of intellectual property rights and for contractual risk arrangements. Insofar it looks over-protective. But in practice it simply cannot be said whether the eventually successful launch of a new pharmaceutical product is due to a “hidden value” which existed when the underlying IP right was transferred to a low-tax subsidiary or whether it is generated by value-increasing expenditure incurred after the transfer (like marketing efforts) or whether it is simply due to a “lucky” beneficial market situation. Against this background, OECD has a point in assuming that independent parties might have entered into \textit{ex post} adjustment clauses or renegotiation clauses which allow for hindsight allocation of profits\textsuperscript{103}. But it is not the information constraint between hypothetical contractual parties which matters. It is the information constraint of the involved states that should give rise to \textit{ex post} control of the profit assignments.

e) Conclusions on the Arm’s Length Standard

At this point it can be concluded that the application of the arm’s length standard to contractual risk allocation can work quite well. The paramount issue is the symmetry of upside risk and downside risk when it comes to risk shifting between affiliated companies. In this context, the plea of OECD to test the “risk-bearing capacity” of the party assuming the risk

\textsuperscript{102} OECD Transfer Pricing Guidelines 2010 para 3.72 et seq. ("Valuation highly uncertain at the outset and unpredictable events") and para 9.87 et seq.; Bullen supra n.7, p.518 et seq.

\textsuperscript{103} OECD, Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, 30 July 2013, para 199 et seq. ("Arm’s length pricing when valuation is highly uncertain at the time of the transaction").
makes a lot of sense. Contrary to this, the concept of “control” does not lead us very far as there exist many efficient arrangements in the business world where risk and control diverge (insurance, corporations).

Nevertheless, there are two cases where it makes sense to deviate from any comparison with third-party contracts:

- The first example concerns risk premiums. Within a multinational group, it makes no sense to charge risk premiums between group members. This is due to the fact that risk premiums are related to the risk profile of the investor. For companies which belong to a corporate group, the final allocation of risk lies always with the shareholders, so it makes no sense to shift profits by charging risk premiums between these group members.

- The second example concerns the transfer of intangibles. As it is merely impossible to assess whether the transfer price for an IP right or a similar entitlement fully captures the value of the intangible, it makes sense to tax the resulting profits on an ex post basis as laid out in the commensurate-with-income standard of U.S. law and similar domestic regulations found in other countries. This also affects contractual risk allocation. This is due to the fact that it is sometimes impossible to distinguish to which extent any ex post profit is due to the hidden value of an intangible and to which extent it is simply related to the crystallization of the upside potential of risk. Given this ex post perspective on the taxation of the transferor, it is evident that such a provision in the tax code will induce the involved group companies to agree on such an adjustment from the start.

3. Source Taxation of Income from Risky Activities

While the preceding part of this article deals with the allocation of income from risky investment to the involved companies, the outcome of this analysis does not pre-empt in full the allocation of taxing rights between countries with respect to this income. Insofar one should think about the option to introduce further-reaching source taxation for foreign-based group members if they benefit from risky activities which have a territorial link to the relevant jurisdiction. A case in point is the taxation of a foreign manufacturing company which sells its products in a jurisdiction via a local commissionaire. While it is highly disputed whether the local commissionaire can be transformed into a local permanent establishment, one can think of establishing a taxing right for the source state on the basis of taxation of inbound sales and services.

A similar way to tax income from risky activities at the level of source can be applied to captive insurance companies. By changing the international allocation of taxing rights, they can be forced to pay taxes on the premiums they receive in the countries where their customers are located. The same holds true for IP holding companies owning intangibles with respect to the royalties they derive or financial companies providing hedges with respect to their respective income. The fact that they are located abroad does not prevent an international
tax arrangement which leads to source taxation of any of these profits from inbound sales, licenses and service agreements.

But one should bear in mind that this allocation of taxing rights is inevitably not restricted to “risky” activities and should therefore be discussed in the larger context of the future allocation of taxing rights between countries exporting sales and services and countries importing sales and services.

4. International Tax Allocation and the Deficiencies in Loss Compensation

This leads us back to the question of whether countries should go beyond the preceding analysis and proposals and restrict the tax effects of contractual risk shifting by multinational groups in general. Insofar, we have dealt with two elements which contribute to the problem: the taxation of risk premiums (which we plead should not be recognized in intra-group situations) and the taxation of “hidden intangibles” (which we plead should be taxed on an ex post basis which does not distinguish between rents and risky income).

The remaining major factor which induces a country to tax income from risky activities and to attract risky investment lies in the denial of full tax credits when companies are in a loss-making situation. Insofar, there seems to be no justified claim of any given country to be allocated this risk, as the tax legislator wants to benefit from self-made restrictions to tax relevant loss compensation. But these restrictions evidently lead to non-efficient results for the taxpaying investor. Insofar, the taxpayer who transfers risky investment and risky activities to a low-tax jurisdiction simply seeks shelter against the negative impact of an asymmetric tax system applied in the high-tax jurisdiction. This is not a move which is subject to criticism under the aspect of “tax fairness” as the legislator itself does not deal even-handedly with the upside risk and the downside risk of the relevant business activity.

Moreover, it is not clear why one country should have a priority right over another country in this respect. Contractual risk arrangements which are agreed between taxpayers located in different countries do not have a “natural” location in one of the involved jurisdictions. These countries are free to agree on source taxation with regard to the activities performed in this context but they cannot claim that the financial “risk” involved is more related to one country than to another. Insofar, there remains a certain leeway for multinational groups to allocate risk between group members (and between jurisdictions). But the constraints proposed in the preceding chapter (on risk premiums and on hidden intangibles) should suffice to ensure that risk shifting does not result in profit shifting. Rather than trying to benefit from insufficient tax provisions on loss compensation, countries should rather try to improve the symmetry of tax provisions on gain losses in order to attract investment in an efficient fashion.

V. Conclusions
International taxation of risk is an under-researched topic. While the interaction of tax provisions and investment are largely understood for the domestic situation, there exist only very few systematic inquiries into the effects of risk-taking on international taxation.

There is a growing trend in international tax policy to counteract risk-shifting within multinational firms. In particular, the OECD Report and the OECD Action Plan on BEPS propose to constrain intra-group risk allocation in order to rely on taxation of “real activities”.

Risk shifting as such is tax neutral. But there exist three reasons why states are interested in the taxation of risky investment or activities:

- The denial of full loss offset (or a negative income tax) induces countries to put their hands on risky income as the tax revenue from the upside will exceed the tax revenue loss from the downside. This is particularly true for a source state which is not obliged to grant compensation with foreign income.
- The existence of risk premiums leads to an overall positive revenue for the states.
- Risk shifting might be used to “hide” the transfer or income-generating intangibles.

The arm’s length standard in general justifies the recognition of intra-group risk arrangements. But there are limits:

- Any assumption of risk has to be fully compensated (either by a fixed fee or by an increased participation in the upside potential).
- The capacity to bear the risk has to be taken into account in order to avoid a “throw-back” of the risk to the other party (and to the other jurisdiction).
- The notion of “control” should not be overestimated given the fact that contractual relations between third parties largely contribute to a divergence of risk and control.
- Risk premiums between group members should not be recognized, given the fact that the outcome will hit the same shareholders anyway; there is no “risk aversion” between affiliated companies.
- Income from transferred intangibles should be taxed on an ex post basis (“commensurate with income” standard) as it is extremely hard to disentangle the factors contributing to the actual income generated by the intangible (rents or risks?)
- If governments want to go further they should consider taking income from inbound sales, services, interest and royalties. These considerations would go far beyond the notion of “risk” and affect in a major fashion the international allocation of taxing rights.
- No country has a justified claim to tax risky activity in order to benefit from the existing asymmetries of its own tax system (in particular the constraints to the compensation of losses or the lack of a negative income tax).