 COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFT

BEPS ACTIONS 8, 9 AND 10: REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERISATION, AND SPECIAL MEASURES)

10 February 2015
<table>
<thead>
<tr>
<th>Table of contents</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABI</td>
</tr>
<tr>
<td>AFME-BBA</td>
</tr>
<tr>
<td>Ágata Uceda</td>
</tr>
<tr>
<td>Alessio Rombolotti Axelrod</td>
</tr>
<tr>
<td>AlixPartners LLP</td>
</tr>
<tr>
<td>Amir Pichhadze</td>
</tr>
<tr>
<td>AOTCA (Asia Oceania Tax Consultants'Association)</td>
</tr>
<tr>
<td>Asociacion Argentina De Estudios Fiscales -AAEF</td>
</tr>
<tr>
<td>AstraZeneca</td>
</tr>
<tr>
<td>Australian Bankers' Association Inc</td>
</tr>
<tr>
<td>Banking and Finance Company Working Group on BEPS</td>
</tr>
<tr>
<td>Barsalou Lawson Rheault</td>
</tr>
<tr>
<td>BDI</td>
</tr>
<tr>
<td>BDO</td>
</tr>
<tr>
<td>BEPS Monitoring Group</td>
</tr>
<tr>
<td>BIAC</td>
</tr>
<tr>
<td>BUSINESSEUROPE</td>
</tr>
<tr>
<td>Canadian Bankers Association</td>
</tr>
<tr>
<td>CBI</td>
</tr>
<tr>
<td>CIOT</td>
</tr>
<tr>
<td>CLHIA (Canadian Life and Health Insurance Association)</td>
</tr>
<tr>
<td>Confederation of Indian Industry (CII)</td>
</tr>
<tr>
<td>Confederation of Swedish Enterprise</td>
</tr>
<tr>
<td>Deloitte LLP (UK)</td>
</tr>
<tr>
<td>Deloitte</td>
</tr>
<tr>
<td>Diamond</td>
</tr>
<tr>
<td>DRTP Consulting</td>
</tr>
<tr>
<td>Duff’and Phelps</td>
</tr>
<tr>
<td>EBIT</td>
</tr>
<tr>
<td>EY</td>
</tr>
<tr>
<td>Federation Bancaire Francaise</td>
</tr>
<tr>
<td>Fédération Francaise Des Sociétés D'Assurances</td>
</tr>
<tr>
<td>FIDAL</td>
</tr>
<tr>
<td>Gazprom Marketing and Trading Ltd</td>
</tr>
<tr>
<td>GFIA</td>
</tr>
<tr>
<td>Grant Thornton International Ltd</td>
</tr>
<tr>
<td>Grove Tax Policy Institute</td>
</tr>
<tr>
<td>Harris Consulting &amp; Tax</td>
</tr>
<tr>
<td>Horst Frisch</td>
</tr>
</tbody>
</table>
I.J.J. Burgers and A.J. van Herwaarden 392
IAPT 394
Ibec 423
ICC (Transfer Pricing and Customs Valuation 2015) 428
ICC 438
ICI 441
IFA Grupo Mexicano 447
IHG 456
Insurance Company Working Group on BEPS 466
Irish Tax Institute 478
The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK’s total net worth and contributing £11.8 billion in taxes to the Government. Employing over 315,000 people in the UK alone, the insurance industry is also one of this country’s major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to protect themselves, their families, their homes and assets, provide for a financially secure future and manage the risks faced in their businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed.

The ABI

The Association of British Insurers (ABI) is the voice of the UK insurance industry, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI’s role is to:
• Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
• Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
• Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
• Promote the benefits of insurance to the government, regulators, policy makers and the public.

Introduction

1. The ABI welcomes the opportunity to comment on the discussion draft. We support the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment. Our comments reflect our desire to ensure that any measures are workable, well targeted, and proportionate in the context of the efficiency of commercial insurance operations. In the spirit of working constructively with the OECD and member governments, we offer information and suggestions as to how the proposals could be improved to help achieve objectives whilst at the same time avoiding inadvertent consequences that impact on the normal conduct of insurance business models.

1 Discussion draft on OECD BEPS Action 8-10 (Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk recharacterisation, and special measures)) released 19 December 2014
Executive Summary

Overall comments

2. We welcome the opportunity to develop increased clarity and a detailed understanding of the impact of risk set out by the OECD in the discussion draft. We understand that in relation to the wording on Chapter 1 of the Transfer Pricing Guidelines, the detail is intended to set out best practice and is therefore a helpful indicator in clarifying the level of detail that should be included in transfer pricing documentation for significant transactions.

3. Although the general principles relating to identification, assessment and management of risk apply at a high level to the insurance industry, because the assumption and management of risk is the core business of insurance, particular consideration needs to be given to guidelines for insurance.

4. Our particular concerns as insurers are:
   I. The need for clear guidelines on the treatment of insurance business which is all about the transfer of risk. In the context of risk, insurance business will not fit into broad general guidance. Detailed and comprehensive guidance in relation to risks and insurance is included in Part IV of the OECD PE guidance and therefore referencing this existing guidance within the proposed Transfer Pricing Guidelines would help obtain such clarity.
   II. Non-recognition of transactions, particularly regulated insurance transactions should only apply in exceptional circumstances.
   III. The instances where delineation of transactions (or recharacterisation) can take place should be expressly limited to those where renegotiation would have clearly taken place between parties at arm’s length.
   IV. Special measures are intended as a ‘last resort’ to tackle issues which fall outside the traditional transfer pricing remit. We believe that it is more appropriate to deal with these through the CFC or other workstreams. If these are included then safeguards are needed for example, a requirement to show that the analysis set out in Part I of the discussion draft has been carried out by tax authorities before any special measures could be invoked.

We are also more concerned generally about the potential compliance burden for business in carrying out the detailed analysis for all transactions and we suggest that a materiality threshold for transactions should be considered.

2 References in this document to the insurance industry refer to all types of insurance including reinsurance unless otherwise specified.
3 OECD Report on the Attribution of Profits to Permanent Establishments, 2010
Insurance specific comments

5. The ability for an insurance entity to assume risk is governed by regulation. Each regulated entity is required to have sufficient capability and capital in their local (or host state for passported entities within the EU) regulated territory to manage risk. Therefore insurance entities are not able to fragment operations without properly supporting the risks taken on. Similarly, there are constraints on the movement of capital within structures and therefore the location of risk and capital will generally have to reflect the economic activities carried out.

6. In relation to the control of risks, insurers can seek to drive behaviour through conditions set out with which policyholders must comply for policies to remain valid. However, this is not the same as control, and instead this risk is factored into the price of an insurance contract. In addition, reinsurers do not control the underlying risks; rather the business model is based on diversification such that any losses can be absorbed whilst remaining profitable. We do not consider that many of the general comments set out in the discussion draft in relation to risk are framed in a way that is directly relevant to insurance operations. Part IV of the OECD’s PE guidance provides detailed and comprehensive guidance defining and discussing risks, risk management and the allocation of risk in the context of an insurance business. This guidance was the outcome of significant consultation with industry and other parties and therefore we consider that the considerations for risk identification and allocation should be linked to this existing guidance.

7. Special Measures are unlikely to be workable for the insurance industry unless they are adapted to recognise the specific differences in the industry. For example, the balance between risk and capital is critical for a regulated insurer. Regulation and other external measures of capital adequacy will impose discipline in this area and therefore excess capital is unlikely to arise. Further comment in relation to all suggested special measures is included in our detailed response.
Detailed response

8. We have aligned the structure of the body of our report with the overall structure of the discussion draft for ease of comparison:

Part I
   I. Identifying the commercial or financial relations
   II. Identifying risks in commercial or financial arrangements
   III. Interpretation
   IV. Non recognition
   V. Specific considerations

Part II – Potential Special Measures

   I. Identifying the commercial or financial relations

9. We agree that comparability is at the heart of the arm’s length principle, that accurate characterisation of transactions together with identification of comparable transactions between unconnected parties is key and welcome the guidance set out within this document in terms of understanding what best practice might look like. It is not clear however how this increased guidance on functional analysis aligns with Action 13 and therefore greater clarity on this would be appreciated.

10. The traditional approach to transfer pricing audits and reviews by tax authorities has been to carry out a one-sided approach to the tested party, reviewing its activities by reference to market comparables. The emphasis of this discussion draft is on the inter relationship of the group and the wider value chain. There is no explanation given as to how this process could be managed by tax authorities or how large multi-national groups could ensure that parties to transactions have the required degree of information in relation to the impact of the transaction on their counterparty without this process becoming unnecessarily onerous.

11. Additionally on this point, the discussion draft appears to move strongly towards an ‘economic family’ type of analysis which is a move away from the traditional approach generally used by taxpayers to assess the arm’s length nature of their pricing. In an insurance group, this idea ignores that there is real risk transfer which drives real economic benefits and capital efficiency between individual members of the group. In addition, each risk-bearing entity within an insurance group is separately regulated and the contractual relationships between them cannot be ignored in the regulatory scheme.

12. There are a number of instances in the draft where retrospective reviews of arrangements are noted. For example at para. 5 in relation to whether the contract accurately reflects the arrangements in place. Whilst we are in agreement that to the extent possible, the transfer pricing policy of the group should reflect the actual activities carried out rather than just reflecting the legal agreements in place, a degree of pragmatism is required. Even in a third
party context it is not inconceivable that the day to day activities under a contract could differ in practice from those documented at the outset. Only to the extent that such differences became economically significant is it likely that third parties would seek to renegotiate contracts. Smaller deviations from initial scope are unlikely to result in renegotiation of terms between third parties. There may also be circumstances where parties to transactions accept a degree of ‘scope creep’ to maintain good relationships with suppliers / customers. Therefore, to the extent that the economic substance of the transaction is broadly similar we do not consider that it is appropriate to ‘delineate’ further additional transactions.

13. Para. 7 notes that there may be situations where the outcome of a transaction is that an additional transfer of value has occurred, even though this was never identified as a transaction by the taxpayer. This language infers that transactions should be reviewed retrospectively to determine whether any additional services have been provided. Such retrospective reviews do not accord with the existing Transfer Pricing Guidelines which refer to information available (or that should have been available) to taxpayers at the point the transaction was entered into and if applied would lead to greater uncertainty and potential double taxation. We also believe that identifying and therefore providing compensation for such transactions does not necessarily reflect the way third parties would interact. Whist we accept that arrangements should be reviewed on an ongoing basis to ensure that the initial agreement and method of pricing is reflective of the continued operation, where additional transactions of value are deemed to have arisen only those which are economically significant should result in tax adjustment i.e. any adjustment for additional transactions should be limited to situations where there would be an adjustment in transactions between third parties. Any proposal to retroactively revisit contract terms would be disruptive to the insurance industry. The payment of protection for risks that may never materialise is core to insurance industry pricing. Protection from risk has economic value even if the risk never materialises.

14. At para. 12 the discussion draft notes that the conclusion which should be demonstrated in assessing opportunities is that the transaction offers a ‘better opportunity to meet commercial objectives than alternative options”. There is no definition of ‘better’ in this context – ie whether it is better economically, reputationally, from a risk perspective etc. In any event, there is a question whether this is the correct test or whether it should be ‘at least equal’ to other options available. This ambiguity may give rise to significant levels of adjustments by tax authorities and an increased compliance burden for taxpayers leading to disputes and possible double taxation.

15. There is an assumption that parties to a transaction within a group have full access to the relevant information for the counterparty or that a central part of a MNE will be involved to oversee all transactions entered into between group entities. For less material transactions within a group this may not be the case even though such transactions may be material from an individual entity perspective. In reality groups often have to make time pressured decisions without perfect information being available. This may also be true for transactions between unconnected parties. Therefore to assume that all possible alternatives are considered in the
case of either internal or external agreements does not reflect the realities of operating a multinational business.

16. The amount of documentation that may be required to document that the detailed comparison process has taken place is likely to be a disproportionate compliance burden to documenting such process. We believe that consideration should be given to whether some type of threshold test should be introduced to reduce the number of transactions to be documented.

17. We recognise the need to ensure that the genuine substance of transactions is documented and reflected in a group’s transfer pricing policy, rather than the legal form. However, the apparent ease with which a tax authority can move to disregard contractual terms and substitute its own interpretation of who is carrying out functions / managing risk is a concern. Such proposals may mean that the tax provisioning process for financial reporting purposes is more onerous, more positions are uncertain and there will be an increased risk of disputes and double taxation.

18. Para. 18 – This example is very unclear as to the point it is intending to address and can be interpreted in several different ways including:

   I. Implicit support from other group companies in a diversified group would reduce the insurance premiums of a subsidiary compared to a stand-alone basis;
   II. Implicit support from the parent company would reduce the insurance premiums of a subsidiary compared to a stand-alone basis;
   III. If the whole group purchased insurance from the same insurance company, this would be cheaper than if each company purchased insurance individually; or
   IV. If the whole group purchased insurance on a global master/local policy basis, this would be cheaper than if each company purchased insurance individually.

   In the absence of explicit guarantees it is unlikely that the interpretations set out in points 1 and 2 above would result in a premium reduction for group entities when purchasing insurance externally in the market. Even explicit guarantees can have limited impact on the amount of capital an insurance company is required to hold by its regulator since the guarantee may have little value in the kind of stress event that gives rise to it.
   Option 3 could possibly result in a discounted price on the basis of a bulk purchasing discount, but we consider it unlikely that it would fully achieve the benefits from pooling risks as each entity is likely to be insured by a local insurance subsidiary owing to local regulatory requirements and therefore the risks are individual risks in each local entity. Pooling benefit is only likely to the extent that the insurance group subsequently reinsured the risks centrally to a group captive.
   Option 4 is the most likely to achieve some pooling benefits of the different options considered, but even this would only be achieved to the extent that the risks were subsequently reinsured centrally to a group captive.
   Therefore it is not clear that the para. as drafted provides the necessary level of clarity intended. Given the level of ambiguity we suggest that this para. should be removed.
Para.21 - Although it is true (subject, in the insurance context, to regulatory constraints) that insurers can to a certain extent split activities over a number of jurisdictions and that they will remain under common control at the highest group level, this is not always the case at a regional or divisional level. Within regulated insurance groups, regulators will generally require entities to transact with group counterparties at arm’s length. In addition, it should be noted that there has been an overall move towards a greater degree of group regulation and central pooling and allocation of capital, driven at least in part by Solvency II, rather than increased fragmentation. Insurance groups are therefore unlikely to artificially fragment their insurance operations. Regulators do sometimes require separation of non insurance activities from the core insurance business to minimise any contagion risk. For example, having employees in separate employment companies. It is not clear in this context what BEPS activities are being prevented.

II. Identifying risks in commercial or financial arrangements

20. Insurance is the transfer of risk between the insured party and the insurance company. The insured party pays a premium to reduce risks and the insurer pools such risks to spread the risks of loss. Insurers do take on risk in relation to which they have little or no control. Rather than controlling the risk, the pricing of the insurance contract reflects the level of risk incurred. Insurers then seek to diversify their own risk portfolio, either through writing additional business or via reinsurance contracts. For information purposes a paper prepared setting out the “Role of Risk and Capital in Insurance” is attached to this document at Appendix A.

21. In relation to the specific question raised at p15, in relation to the financial services sector:

“Is the discussion of risk of a general nature such that the concepts apply to financial activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?”

We do not consider that the general comments set out in the discussion draft can apply to the insurance industry without significant redrafting or adaptation. In summary, as set out in the OECD Report on the Attribution of Profits to PEs, the key part of the value chain which should be remunerated and have capital attributed in relation to it is the assumption and management of risk. Part IV of the report provides comprehensive guidance defining and discussing risks, risk management and allocation of risk in the context of insurance businesses and therefore referencing the relevant existing guidance for the FS industry would seem to be a sensible approach given the time and review which has already gone into this process. On this basis, we believe that the guidance on risk transfers should be linked to the part IV report when considering risks in the insurance industry.

22. In addition to our comments on the Financial Sector specific question, we also have additional comment in relation to questions 1-7 and in particular question 4 (p14). Our overall comments on questions 1-7 are that the probability of a risk outcome (risk–return trade-off), moral hazard and risk controls are all factored into the pricing of an insurance premium. In relation to
question 4, this para. essentially describes an insurance contract, therefore to question whether transactions would be entered into between parties where the sole effect is to transfer risk does not reflect the core activity of the insurance industry.

Arm’s length insurance contracts can and do transfer risk in situations where the party accepting the risk has no control over the risk. Most insurance policies fall into that category, and particularly liability insurance such as professional indemnity.

I. The extent to which such risk is ceded / accepted depends on the objectives/motivations of the parties. Assuming that performance incentives for business and individuals are aligned, the cedant may choose to lay off risks which are within their control but subject the business to a level of uncertainty/volatility which is unacceptable. Insurance is often the most cost effective way to manage that volatility. The accepting insurance group would have sufficient diversification and capital base to accept the volatility, in spite of having no control over the ceded risk.

II. Moral hazard is minimised where the cedant is incentivised to manage the risk (eg. to minimise premiums and maximise business profitability).

III. A cedant might consider retaining the risk or changing the level of risk ceded if the premium was considered to be excessive and the cedant could make arrangements to manage the potential consequences of the risks in question.

23. Para. 38 notes that in the scenario where risk is assumed without safeguards to manage the behaviour of the party creating the risk exposure, moral hazard considerations are likely to apply. It is precisely the lack of ability to control risks and consideration of moral hazard that drives the pricing of insurance contracts. Insurers can drive behaviours via pricing of premiums for example (ie increasing premiums for higher deemed risk based on the facts available at the outset of the agreement) giving consumers the opportunity to modify behaviour to reduce premiums, however once insured there is minimal control over what the insured party does. Catastrophe risk should also be considered in this context for insurers. In view of the above, from an insurance perspective, the statement that parties should be allocated a greater share of those risks over which they have relatively more control does not hold true. Instead risks should be allocated to those capable of accepting and managing such risks and holding the capital to write the business.

24. At a general level much of the discussion draft between paragraphs 43-59 in terms of allocating, assuming and the potential impacts of risks are not relevant for the insurance industry given the specific regulatory and accounting requirements already in place. In this respect, we welcome the later comments at para. 66 noting that the position is different for regulated entities and therefore suggest that rather than regulated insurers being subject to the general guidance on identifying risk the allocating and assuming of risk should be as set out in Part IV on the basis that these considerations are overridden by the regulatory environment within which insurers operate. This regulatory environment has been put in place to offer protection to policy holders and therefore the certainty it affords allows insurers to operate effectively and price competitively. Any changes to the management of capital for example would have a wider effect.
on pricing and availability of insurance in the market, given the importance of being able to
diversify portfolios and move risks to utilise effective capital structures.

25. In relation to the specific regulatory environment that exists for insurers and the implications of
this for the points raised in the discussion draft, we note that the last sentence of para.66, that a
low level of capital does not preclude risk allocation does not hold true in a regulated
environment, where capital of a sufficient quantity and quality is required in order to take on
risk. The final sentence of para. 78, that a party which does not control risk will not be allocated
the risk and therefore will not be entitled to unanticipated profits is also out of line with
transactions observed in the insurance market.

26. To the extent that no blanket exemption for insurance is available, additional consideration
needs to be given to the treatment of reinsurance arrangements in light of the comments on
control of risks in this discussion draft. Under a reinsurance contract the insurer will assume the
initial risk, will maintain the agreement with the customer and will be the party which will be
notified of any changes to the contract and make subsequent decisions as to whether any
changes to the circumstances should result in a continued acceptance of the insurance risk or
changes to the level of cover or price of the premiums. The reinsurer underwrites at a macro
(geographic or segment) level making its own assessment of the risks and writes business up to
its risk limits and available capital, but the reinsurer does not usually underwrite at the contract
level or have any interactions with the insurers policyholders. The example given at para. 60 is
for a manufacturing group whereby product recall risk is documented as remaining with the
distributor however the facts point to this risk truly being mitigated and addressed by the
actions of the manufacturer. Therefore the draft notes that the upside and downside of such risk
should be attributed to the manufacturer. Taking this example and applying it to an insurance
group it could be interpreted that any available controls over the risks assumed (to the extent
that this exists at all as per earlier comments) rest with the insurer rather than the reinsurer as
only the insurer has direct contact with the policyholder. Of course the reinsurer will be
monitoring its exposure from reports received from the insurer and making sure that the insurer
is fulfilling the requirements of the contracts. This example underlines the need for specific
guidance for the insurance industry and as a minimum we suggest that this example should be
specifically noted as not applying to the insurance industry.

27. Para. 67 notes that “Third parties may be unlikely to provide insurance for core competencies
unless they have significant information about and control of potential outcomes due to moral
hazard that the incentive to manage risk by the insured party is lowered.” For insurers this
statement is incorrect, insurers do provide insurance for such core competencies (consider
professional indemnity insurance etc. as well as the reinsurance market) albeit the price charged
will reflect the perceived level of risk assumed and may also insist on appropriate risk
management activities in the insured entity, however insistence on such risk management
processes is likely to fall short of the ‘significant information about and control of potential
outcomes’ threshold. This is another example of why these general guidelines do not fit the
insurance industry and we suggest that this sentence is amended to make it clear that it does not apply to the insurance industry.

28. At para. 72 the discussion draft notes that risk transfer is likely to happen only if the transferee is well placed or better placed to manage risk than the transferor. Within the insurance value-chain the primary insurer is generally best placed to manage the risks assumed under an insurance contract, with a reinsurer managing its risks on an aggregate basis with less control over the primary risks. Furthermore, there is often a series of reinsurance transactions in third party situations which results in the diversification of risk, and each of these transactions results in a reinsurer having less control over the risk than the previous cedant. Therefore, we suggest that this example should be specifically noted as not applying to the insurance industry.

III. Interpretation

29. We welcome the comments at para. 82 which note that the mere fact that a transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm’s length arrangement. Concerns that transactions may not be recognised by taxing authorities give rise to concerns about disputes leading to double taxation and therefore the clarity that it is the fundamental economic attributes that are important rather than the existence of the transaction between unconnected parties is most welcome in this respect.

IV. Non recognition

30. Para. 84 – We welcome the comment around how ‘the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised’. Determining the economic substance of transactions and pricing according to similar economic risk profiles has been an accepted approach for the reinsurance industry and therefore clarification that this is not intended to be restricted by this para. is helpful in managing risk.

31. Para. 86 – it would be useful to have clarity as to whether the wording ‘except in certain regulated sectors, MNE groups have freedom to control their structures” means that the whole section on non-recognition would not apply for regulated entities. The section on non-recognition looks to ensure that artificial transactions are not being created within groups which would not exist between unconnected parties (from an economic attribute perspective rather than replication of the actual transaction). Given the regulatory environment to which insurance groups are subject and the constraints this places on the entity structures in relation to regulated business, there is limited scope to fragment activities in such a way and therefore providing an exemption for regulated entities from such tests could avoid introducing complex tests to determine applicability.

32. In relation to Para. 89 the wording around considering whether the MNE group is left better or worse off on a pre-tax basis, we have the following comments:
I. Firstly, looking at the group as a whole does not align with the separate legal entity approach which has been the focus of groups transfer pricing analysis to date.

II. Secondly, the wording “is left worse off” implies that this would be a retrospective test. Given that reinsurance arrangements are priced prospectively and could result in the transfer of a profit or a loss depending upon whether insurance losses occur, this test would not align with the analysis carried out to evaluate new business opportunities.

III. Depending on the point in the insurance cycle, a party to a reinsurance contract may or may not be worse off, depending on whether a risk event has been realised. This pricing of risk is the core business of insurance and over time is forecasted to give positive returns, although this cannot be guaranteed in any single time period and therefore looking at the performance at an arbitrary point in time does not reflect the commercial reality of the sector.

IV. The non recognition should only be applied in very limited circumstances and there should be safeguards to ensure that a full assessment has been carried out before this is considered.

V. Specific conditions

33. No industry specific comments.

Part II – Potential Special Measures

34. An overarching observation in terms of the special measures is that clear criteria for application must be drawn up so that tax authorities apply them consistently to a targeted set of circumstances. In addition, given the consensus basis of drafting, it will be essential that a mechanism for eliminating double taxation arising is included to address situations where transactions / entities are caught and tax has already been assessed in the other jurisdiction.

35. Option 1 – Hard to Value Intangibles – as noted above, this option introduces retrospective tests and steps away from the arm’s length principle in terms of how parties are likely to transact at arm’s length. We believe that the drafting should be reconsidered to include wording such that as long as the initial arrangements took account of all information available at the time and it would be reasonable for third parties to have concluded on the basis of such information, then no subsequent adjustment should be made in the event that the actual results differed from the budgeted results. As is accepted by the wording of the draft – these intangibles are by their nature ‘hard to value’ and therefore looking at what the reasonable actions of unconnected parties would be is key to determining whether the arrangements are aligned with the actions unconnected parties would have taken when entering into a similar contract.
36. Option 3 - Thick capitalisation - Insurance groups have to operate within very specific regulatory constraints. The key area of focus for regulators in an insurance context is the amount of capital held in the context of managing risk and continued business viability. Balanced against this is the high cost of capital to insurers and the negative result of holding what is seen as an excess of capital by rating agencies and analysts. Therefore it can be seen that the commercial and regulatory constraints already in existence mean that it is extremely unlikely that an Insurance group would hold excess capital. It should be noted that any attempt to define an arbitrary capital ratio is impossible to apply to the insurance industry. Different lines of business require very different levels of capital to be held, e.g., high frequency/low severity risks (e.g., consumer auto) may not require much additional capital to be held, but low frequency/high severity risks (e.g., property catastrophe covers) may require substantial capital buffers.

Given the regulatory environment in relation to risk and capital we would strongly recommend that if such rules are introduced, special rules are developed for the insurance industry.

37. Option 4 – Minimal functional entities. Although it is helpful to have clear examples of the types of activity which may lead to an assessment as a minimal functional entity, we have concerns that a strict interpretation of the current wording may deem certain entities within an insurance group as minimal function entities. In particular the wording around the quantitative attribute, specifying that to be viewed as a minimal functional entity the “company in substance performs mainly routine functions”, as well as the attribute in relation to whether “a substantial part of the company’s income is from arrangements with group companies” may give rise to profit reallocation for the activities in the reinsurance industry if this measure was interpreted to demonstrate minimal functionality as a stand-alone test.

From a regulatory perspective, insurers have to separate out the insurance component of their business from their service centres / employing entities. By their nature, these entities will rely solely on group companies for their income, and in the case of a service centre, will perform mainly (only) routine functions.

Therefore we suggest that further drafting of these measures is carried out to ensure that they are properly targeted and in addition, that no one qualitative or quantitative measure alone should be a decisive indicator of minimal functionality.

38. Option 5 - Ensuring appropriate taxation of excess returns. This is more of a CFC rule than a transfer pricing one. We do not consider that there are any transfer pricing actions that could prevent excess returns in low tax jurisdictions and therefore this may be better addressed within Action 3 on CFCs. It is also unclear how the test on the CFC’s customer location would work in the context of the EU where cross-border operations are encouraged through freedom of services protections. There is insufficient information about how a secondary rule could apply to comment here, but it is clear that should such a rule be drafted, there would need to be safeguards within the rule to ensure that taxing authorities do not use such powers in a non-commercial way.
Appendix A – Role of Risk and Capital in Insurance

Executive Summary

Through the Base Erosion and Profit Shifting (BEPS) Project, G20 and OECD countries are more closely aligning taxation with economic activity and value creation. A key action of the BEPS project relates to risks and capital, where the concern is that ‘inappropriate returns will accrue to an entity solely because it has contractually assumed risks or has provided capital.’ This concern arises because tax authorities have encountered situations where a multi-national group’s profits have been shifted between jurisdictions through artificial risk transfer (i.e. where actual risk does not follow contractual risk); where capital is moved to where it is not needed; and where contractual risk is divorced from the functions which manage risk.

For insurers, risk and capital cannot be separated; there can be no assumption of risk without the provision of appropriate capital in an insurance context because the regulatory capital rules which (re)insurers are subject to are designed to ensure that the person bearing the risk of loss has the capital available to meet such losses. Inevitably, the assumption of risk can lead to loss as well as profit and it is the capital provider to which both arise. This is why this function is rewarded. The Insurance industry is concerned that any new rules which seek to limit the allocation of returns to an entity ‘solely because it has contractually assumed risks or has provided capital’ could inadvertently impact legitimate insurance business models where both these things go hand in hand.

As a contribution to the BEPS project, this paper is offered as an explanation of the unique role that risk and capital play in the insurance industry, in order to demonstrate that insurance risk transfers are by their nature real transfers of risk (even where intra group), that insurance companies have strong commercial reasons not to hold excessive capital or move it to where it is not needed, and that the management of insurance capital (which is analogous to the raw materials used by other industries) can be done by comparatively few but appropriately qualified staff. Insurance is a highly-regulated industry, and these regulations, along with existing transfer pricing guidelines, give tax authorities and governments wide powers to challenge or disregard any intra-group insurance transactions which result in profits or losses that are not aligned with economic activity.

Intra-group reinsurance contracts perform the same role as external reinsurance contracts, and should be priced in the same way, i.e. on the basis that residual profits and losses are returned to the key entrepreneurial risk-taking (‘KERT’) function/capital provider after remunerating other functions (such as brokers or sales agents), as there is simply no other party that bears the insurance losses.

This note applies to groups where the main or one of the main activities is the conduct of insurance business. It does not consider captive insurance companies of groups whose main activity is not insurance.
Insurers play a unique role in the global economy, protecting individuals, businesses, and governments against financial loss from risks ranging from natural catastrophes to poor health and unemployment.

The essence of insurance is the transfer of risk between the insured party and the insurance company. In exchange for the payment of a premium, an insured party can transfer to an insurer the risk of loss from a particular source. By pooling the risks of multiple insured parties, the insurer can spread the risk of loss. To ensure it will be able to pay any claims that arise beyond those expected, the insurer holds an appropriate amount of capital. The first risk in the insurance supply chain that an insurance company takes on is by definition from an independent third party.

An insurer assumes a variety of risks in relation to the business it writes:

- **The main risk is insurance (or underwriting) risk**, i.e. that factors beyond the insurer’s control result in claims that exceed premiums and other income and the insurer makes a net loss. Examples of these factors include severe or frequent natural disasters such as earthquakes, storms and floods, or people falling ill and/or living longer or not as long.
- Other insurance specific risks exist, e.g.:
  - Reserve risk: the risk that original estimates of claims are ultimately too low due to changes in inflation, court decisions on damages etc
  - Market risk: the risk that the investment assets held to support both the claims reserves and the solvency capital of the insurer fall in value due to underlying market conditions
- Insurers must also manage general business risks such as **credit risk**, expense risk, and **operational risk**.

Risk management is at the heart of the insurance business; insurers cannot eliminate risk and volatility but their objective is to understand and manage it. The **key decisions an insurer makes relate to which risks to take on and what premiums to charge** - in order to make profits, an insurance company must get the correct balance between these two factors. Accordingly, the understanding and management of insurance risk is at the heart of an insurer’s ability to create value.

One of the key methods for managing risks is through **diversification of risk**, or in other words reducing the concentration of one type of risk by writing many different types of policies. Diversification of risk can be achieved by writing business in different geographical locations (because there is little correlation between losses in different locations e.g. earthquakes in Japan versus Wind/Winter storm in Europe), or it can be achieved by writing products that partly offset each other (such as whole-of-life assurance and annuity contracts because there is a negative correlation between claims for these types of risks). "Diversification, particularly geographic, is
fundamental to the insurance business”. It reduces the overall risk of unexpected loss to the portfolio as a whole and therefore reduces the need for capital. As the cost of capital is a key factor in setting premiums, the efficient management of capital is critical to competition between insurers.

Insurers hold reserves to cover all expected risks and, as regulated entities, the (minimum) size of these reserves is determined by local regulatory rules. These rules can vary widely, though from 2016, the Solvency II regime will govern all European Union insurers and many other governments are developing new regulatory rules that follow the same fundamental concepts as Solvency II. Whilst Solvency II does not apply outside the EU, EU insurance companies who reinsure to locations outside the EU will need to demonstrate that the local regulations are ‘equivalent’ to Solvency II, or be sufficiently capitalised under Solvency II rules, in order to get regulatory credit for the reinsurance (more about reinsurance later). One of the main changes in moving from Solvency I to Solvency II is that Solvency II requires more accurate modelling of the underlying economic risks. Solvency II rules are outlined further in Appendix I.

**A real loss can and often does arise from the risks insurers manage** as the underwriting results from the Association of British Insurers (‘ABI’) members for the 17 years to 2012 below demonstrate.

![Underwriting result for all lines of general insurance, £bn](image)

Furthermore, a single large natural catastrophe or other unexpected event or mismanaged financial risk can wipe out several years’ worth of earnings.

Recent examples of large unforeseen events include the impact the recession and the consequential fall in global markets had on life insurers providing variable annuity products in 2008/2009, and the general insurance market in 2001 after the terrorist attacks of September 11th, and in 2005 after Hurricane Katrina. In each of these cases, substantial underwriting losses occurred.

Insurers are able to bear losses arising from insurance risk as they hold capital reserves against such events. For this reason, in insurance transactions (whether between related or unrelated parties), the capital provider receives the residual profits and losses after remunerating other functions (such

---

4 Insurers Rating Methodology: Standard & Poor’s, 7 May 2013
as brokers or sales agents), as the reward for the capital it has placed at stake. The capital provider is the entity that bears the risk of an insurance loss, and earns the return on the capital at stake should no loss arise in the period.

Capital

For most companies, capital is simply defined as the excess of assets over liabilities. The position is more complicated for insurance companies, with multiple capital requirements arising from regulators and ratings agencies. The capital position of an insurer is regulated by local regulators (government bodies), who set a minimum amount of capital which must be held by an insurer to cover expected liabilities plus a margin for additional security, in order to ensure that policyholder claims will be met even where these are greater than anticipated. (See Appendix I)

Insurance entities must be approved and licensed by the relevant country regulator before they are permitted to write local insurance business in the territory. Regulators will not allow the risk of insurance loss (and therefore of profit) to sit with any party except the capital provider as a safeguard for local policyholders; for example an insurance broker or a sales agent would not be allowed by the regulator to accept insurance risk on their own account (without being regulated as an insurance company) as they may not have the financial reserves to cover the potential losses under the contract. Only the (authorised) party which holds the required capital may accept insurance risk.

Regulators also set limits around the amount and type of capital and debt an insurance company can utilise to meet its regulatory capital requirements. Because of this restriction, as the table to the right illustrates, insurers tend to hold a much greater proportion of equity capital in relation to debt than other industries. The S&P 500 column shows the debt/equity ratio for all companies listed on the S&P 500 versus their credit rating, whereas the A.M. Best (as a specialty insurance credit rating agency) column shows their expected debt/equity ratio for an insurance group for the same credit rating. This demonstrates that any losses that arise must be borne by the insurers out of their equity reserves, making the possibility of financial loss to the equity holders a very real one.

Equity capital is expensive in every industry, as tax rules in most jurisdictions allow deductions for interest payments, but not dividends, and shareholders require a higher rate of return than debt holders in exchange for the higher risk they take on as owners of the business. Capital is particularly expensive for insurers, as regulators, and effectively Rating Agencies, and corporate customers and their brokers, force insurers to hold high quality capital in excess of expected liabilities, and limit the amount and type of debt that may be included in regulatory capital.
There is a natural tension between the minimum amount of capital required by regulators and ratings agencies, and the maximum amount of capital an insurance group can use effectively.

Ratings agencies provide opinions, such as the Financial Strength Rating, based on an insurer’s ability to meet its senior financial obligations, which are its obligations to policyholders. Many corporate customers will only contract with insurance groups which have high credit ratings (for example A or above) as this provides more security that the insurer will be able to pay claims even where losses are unexpectedly high.

However, there is a strong incentive not to hold too much capital. **Being over-capitalised means that the insurer will not be able to earn an acceptable return on capital, which will damage its ability to attract and retain investors.** If an insurer cannot earn an acceptable return on capital (e.g. by expanding into new markets or writing new lines of business) it will often return the capital to shareholders. There are many recent examples of general insurers returning capital to shareholders after a string of good years in which there have been few natural disasters, but no additional appetite in the market for increased levels of business.

For insurers, capital is analogous to the raw materials used by other industries, and insurance risk cannot be accepted without holding the required level of capital. Unlike using other raw materials, however, we will show below that that putting capital to work in insurance and, in particular, reinsurance does not necessarily require a large workforce.

**Managing risk and capital through reinsurance**

One of the most important ways that insurers balance risk and capital requirements is via reinsurance agreements, or in other words **insurance for insurers.** A reinsurance agreement takes a single large risk or a collection of risks written by the original insurer and transfers them to a reinsurer, in return for a premium. The result is that risk is removed from the liabilities of the original insurer and the insurer is freed from the requirement to hold capital against the risk. This requirement is instead passed to the reinsurer who now bears the risk of loss.
Examples of reinsurance treaties are an excess-of-loss treaty where a reinsurance company agrees to cover losses that go above a certain limit, and a quota-share treaty where a reinsurance company receives a percentage of the premiums that an insurance company writes in return for paying the same percentage of claims. Please see Appendix II for a more detailed discussion of types of reinsurance business. Reinsurance is simply a type of insurance, and many insurance companies write both direct insurance business and reinsurance business.

Reinsurance is a common market transaction, used by insurers all over the globe to remove risks from their balance sheets in order to manage capital and solvency requirements more effectively and reduce earnings volatility. As noted above, insurers cannot eliminate risk and volatility but they can understand and manage risks (partly through reinsurance) in order to balance the ability to pay claims with the ability to make profits for their investors.

The table below shows the gross and net reinsurance premiums written by the largest reinsurance groups - the difference between the gross and net premiums written shows that even large reinsurance groups reinsure some of their risks to other reinsurers.

| Top 10 Global Reinsurance Groups |Ranked by unaffiliated gross premium written in 2013|(USD millions) | Gross | Net |
|---|---|---|
|1| Munich Reinsurance Co |38,333 |36,638 |
|2| Swiss Re Ltd |32,934 |30,478 |
|3| Hannover Re AG |19,225 |16,833 |
Reinsurers, like insurers, take on risk in order to make profit, so the key decisions a reinsurer makes are the same as those of an insurer, namely which risks to take on and what premiums to charge.

By selectively ceding or taking on risks, both insurers and reinsurers can achieve a better balanced book of risks which will not only reduce capital requirements by reducing volatility of earnings as excessive losses may be avoided, but also because losses from one line of business should be offset by profits from another.

### Commercial drivers for insurers to reinsurance risks

<table>
<thead>
<tr>
<th>Reinsurer</th>
<th>Premium Income</th>
<th>Capital Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lloyd's</td>
<td>15,614</td>
<td>11,329</td>
</tr>
<tr>
<td>SCOR S.E.</td>
<td>14,116</td>
<td>12,570</td>
</tr>
<tr>
<td>Berkshire Hathaway Inc</td>
<td>12,776</td>
<td>12,776</td>
</tr>
<tr>
<td>Reinsurance Group of America Inc</td>
<td>8,573</td>
<td>8,254</td>
</tr>
<tr>
<td>China Reinsurance (Group) Corp.</td>
<td>7,936</td>
<td>7,523</td>
</tr>
<tr>
<td>Korean Reinsurance Co.</td>
<td>5,623</td>
<td>3,635</td>
</tr>
<tr>
<td>PartnerRe Ltd</td>
<td>5,562</td>
<td>5,391</td>
</tr>
</tbody>
</table>

Source: A.M. Best

Consumers benefit from reinsurance in the form of more competitive premium prices, a stronger capital base for the insurer (making it more likely that their claims will be paid) and a wider range of risks that can be underwritten (making it less likely that they will be denied coverage for larger or more complex risks). In particular, as natural disasters have been increasing in frequency and...
severity and as individuals have been enjoying longer lifespans and are increasingly responsible for their own retirement incomes, consumers need well-priced solutions in order to achieve financial security.

It is important to remember that in order to obtain the desired solvency and capital effects, a reinsurance contract must be of a type recognised by regulators and accounting rules with a sufficiently capitalised counterparty, and must genuinely transfer risk from one insurance entity to another. Neither regulators nor accounting standards would recognise a reinsurance treaty that did not actually transfer risk, nor would it be recognised in law as insurance, so there would be no purpose in such a contract.

Reinsurance contracts are written both domestically and cross-border, depending on the circumstances of the parties and the types of risks being reinsured. As a result, reinsurance business is not concentrated in any particular location, but is written in many jurisdictions around the world, as demonstrated by the chart to the left (note: A.M. Best treats the domicile of the group as the location of the reinsurance). This is important to enable better diversification of risks.

Source: A.M. Best

Differences in business models of insurers and reinsurers

There are important differences in the business models of insurers and reinsurers which mean that the numbers and types of staff required to manage the business are very different.

Most insurers tend to write a large number of relatively small policies, which means that they need significant numbers of staff to develop and sell products, administer policies, and handle claims. Even where an insurer reinsures a risk, the insurer remains contractually responsible to the insured party for the administration of the policy and the payment of any claims, and so needs to maintain staff to carry out these functions.

In contrast, reinsurers write a relatively small number of policies for large amounts, and so have significant benefits of scale. In addition, reinsurers do not deal directly with consumers (as the insurer retains that responsibility) so do not have significant sales or administrative staff and are able to maintain a lower operating expense ratio than is the case for insurers. This is the reason why
a reinsurer often pays a ceding commission or other contribution to the original insurer’s operating expenses.

Model of insurance staff allocation

Model of reinsurance staff allocation

A high-level look at two of the largest insurers and reinsurers demonstrates the different scale of staff required to support each. As the table below demonstrates, the reinsurers are able to write a large amount of business with relatively few staff, whereas the business of the insurers is much more staff-intensive:

<table>
<thead>
<tr>
<th>Ratio of Staff to Gross Written Premiums (GWP) (USD millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurers</td>
</tr>
<tr>
<td>Munich Reinsurance Co</td>
</tr>
<tr>
<td>Swiss Re Ltd</td>
</tr>
<tr>
<td>Insurers</td>
</tr>
<tr>
<td>Allianz Group</td>
</tr>
</tbody>
</table>

Source: Annual Reports

$^{1}$ Reinsurance business only - direct business excluded

$^{2}$ Staff numbers for reinsurance estimated from annual report

It is important to note that for both insurers and reinsurers, the key decision makers are those who select and price risks, as these decisions have the largest impact on the profitability of the insurer.
Transfer pricing guidelines describe this function ("the assumption of insurance risk") as the KERT function in insurance business, which means that the profits and losses relating to that assumption of risk should accrue to the location where these decisions are made. As capital is required to be held against the risks taken on by an insurance entity, the location in which the KERT function takes place is also the location where the capital relating to the business is held (or attributed in the case of an insurance branch).

The underwriters and actuaries that make the decision to assume insurance risk will be highly skilled but the requirement for such staff will be driven by the volume of decisions to assume insurance risk taken by the company; so for a typical reinsurer, who writes a smaller number of policies than an insurer, there will be a need for fewer underwriting and actuarial staff, and indeed for a smaller number of staff in general. The result is that in a reinsurance context, relatively few highly-skilled staff make the decisions about how to use the capital of the company.

Intra-Group Reinsurance

Regulatory and other rules prevent insurance groups from operating as a single entity. Therefore, in many countries, insurers need to operate via locally regulated and authorised subsidiaries or via permanent establishments, which often have to hold assets to back potential claims to policyholders in regulated ringfenced funds. However, such separation is commercially problematic and intra-group reinsurance is used to counter those problems.

The first risk in the insurance supply chain that an insurance company takes on is by definition from an independent third party; however, many groups manage their risks and capital via a programme of internal and external reinsurance contracts. There is no distinction from a regulatory perspective between internal and external reinsurance and the same requirements must be met from a risk transfer perspective in order to obtain the capital benefit from the reinsurance. There is a real impact to the cedant and the reinsurer in terms of de-risking and diversification.

The commercial drivers for insurers and reinsurers are exactly the same for intra-group reinsurance, namely to manage capital and solvency requirements more effectively and reduce earnings volatility. These drivers apply equally to intra-country reinsurance and cross-border reinsurance. However both the group and consumers may derive further commercial benefits from internal reinsurance. By centralising capital the group and consumers will benefit from:

- **Lower capital requirements and hence higher Return on Equity** – the diversification of risk via intra-group reinsurance reduces the total capital the insurance group needs to hold as the combined underlying risks have a reduced aggregate payout in a stress (i.e. large loss) scenario. This avoids a reduction in Return on Equity that would deter investors.

- **Flexibility of capital use**: reinsuring business is usually faster and cheaper than carrying out a full legal transfer of business around the group, especially cross-border, which:

---

5 Part IV, paragraph 69, of 2010 OECD Report on the Attribution of Profits to Permanent Establishments
avoids the need to put excess capital into jurisdictions where it is difficult to remove at a later date and
allows groups to write insurance in locations where political or economic instability would otherwise make investing unattractive.

- **Improved liquidity** - reinsurance gives groups the ability to move cash around the group to where it is needed (via premiums) or raise funds (for example through the securitisation of a particular book of business which can be assembled via reinsurance), ensuring funds exist to pay claims following large losses, and also reducing third party borrowing.
- **Reducing localised problems** - the group as a whole can write business that the local insurance company does not want to keep on its books, e.g. due to risk concentration levels in a subsidiary or insufficient capital, and centralise risks to achieve balance and diversification of risk.
- **Centres of excellence** - by concentrating one line of business in one location, groups can develop teams with deep expertise in particular types of risk, and by sharing information from different transactions, the group can build valuable commercial information.
- **Improved bargaining power** - with external reinsurers, by bundling risks the group does not want to keep into one larger package, the group is able to more effectively structure its reinsurance coverage and negotiate a better price from an external reinsurer.

These features promote competition in the market by allowing insurers to write business at lower premium levels, which drives down prices for consumers. They also mean that insurance groups are better able to manage their capital and liquidity, so they are more likely to have the financial strength to pay claims even after unusually high levels of loss. By making insurance more reliable, affordable and available to the widest possible market, more consumers can benefit from the financial stability offered by insurance and from lower premium rates.

Regulators will review internal reinsurance contracts, often prior to inception, to ensure that the terms and conditions, often including the price, and the credit-worthiness of the reinsurer are sufficient to ensure that the policyholders are protected, and not adversely impacted by the reinsurance. If regulators do not permit the reinsurance treaty to be factored into the determination of solvency capital or claims reserves for the insurer, then the insurer does not obtain the required capital benefit.

Internal reinsurance contracts are required by transfer pricing rules to be on the same terms and conditions as external reinsurance contracts, and take the same legal form (please refer to Appendix II for examples). Existing transfer pricing guidelines already require that a ‘purported allocation of risk is consistent with the economic substance of the transaction’ for a controlled transaction; if the contractual risk is not consistent with the economic substance, tax authorities may challenge or disregard the transaction, which protects tax authorities from artificial transfers of risks between group entities.

In addition to existing transfer pricing guidance, the new transfer pricing documentation guidelines which will be adopted as part of the BEPS project (Action 13) will give tax authorities an increased

---

6 Paragraph 1.48, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, dated July 2010
amount of information with which to assess transfer pricing risks. For example, the Local File will require groups to set out explicitly the amounts a local entity has paid or received for each category of controlled transactions, along with copies of material intercompany agreements. The Country-by-Country template will show tax authorities how profits and losses are spread across jurisdictions, and how these figures relate to tax paid and capital. With these tools, tax authorities will be able to ensure that profits and losses arising in each jurisdiction are aligned with economic activity and value creation.

Conclusion

Insurance and reinsurance transactions, whether internal or external, are governed by regulators and are genuine, legitimate transactions. Regulators set rules about who can write insurance, what reserves and capital must be held, and (in some cases) what governance and other processes an insurer must have, and these rules encompass the effective use of reinsurance.

For insurers (including reinsurers), the decision to assume insurance risk is the KERT function, as it is this decision that puts capital at risk, though this function can be performed by a relatively small number of appropriately qualified staff. Existing transfer pricing guidance ensures that in an internal reinsurance contract, groups should be able to demonstrate that there are:

- Clear commercial benefits (such as capital benefits)
- Real transfers of risk
- Appropriate staff making the decision to assume insurance risk in the territory.

Providing these criteria are satisfied, intra-group reinsurance contracts perform the same role as external reinsurance contracts, and should be priced in the same way, i.e. that residual profits and losses are returned to the KERT function/capital provider after remunerating other functions (such as brokers or sales agents), as there is simply no other party that bears the insurance losses.

There is a strong incentive not to hold too much capital. If an insurer cannot earn an acceptable return on capital (e.g. by expanding into new markets or writing new lines of business) it will often return the capital to shareholders. Being over-capitalised means that the insurer will not be able to earn an acceptable return on capital, which will damage its ability to attract and retain investors.
Appendix 1

Insurance groups must hold sufficient regulatory capital to cover the risk of their assets not being sufficient to cover their insurance liabilities. Capital adequacy standards define the amount of capital which an insurance company must hold and detail the characteristics which regulatory capital must meet in order to qualify as such. Debt instruments, which form an integral part of the regulatory capital of insurers, have certain equity-like features (relating to loss absorbency and interest deferral) which are mandated by regulators for the protection of policyholders. This means that these debt instruments can fall within some definitions of a hybrid instrument for tax purposes. However, these equity-like features which are mandated by legislation are not designed to give a tax mismatch and are essential in supporting the trading operations of the insurance industry.

The Solvency II Directive\(^7\) codifies and harmonises insurance regulation in the EU and is scheduled to come into effect on 1 January 2016. Capital adequacy standards will become more stringent under Solvency II for EU (re)insurance companies, to reduce the risk of insolvency. The regime is intended to be more sophisticated and risk sensitive than the current insurance regulatory regime.

Under Solvency II, the required regulatory capital of an insurance company is be divided into 3 'tiers'\(^8\) (Tier 1 to Tier 3) based on both its 'permanence' and its 'loss absorbency' characteristics. The "tier" of capital in which an instrument falls will be determined by factors such as its quality, liquidity, duration, permanence and the obligations of the insurer under its terms to pay distributions or interest. Tier 1 is the capital of the highest quality and the majority of an insurer’s regulatory capital must be Tier 1 capital. The majority of regulatory debt instruments are designed to fall within either Tier 1 or Tier 2.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Capital Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets at market value, adjusted for goodwill and other intangibles</td>
<td>Ordinary share capital</td>
<td>Tier 1</td>
</tr>
<tr>
<td></td>
<td>High quality financing</td>
<td>At least 50% of SCR</td>
</tr>
<tr>
<td></td>
<td>Retained earnings</td>
<td>At least 80% of MCR</td>
</tr>
<tr>
<td></td>
<td>Lower quality financing</td>
<td>Tier 2</td>
</tr>
<tr>
<td></td>
<td>Ancillary own funds</td>
<td>Max of 20% for MCR</td>
</tr>
<tr>
<td></td>
<td>Other instruments</td>
<td>Ancillary funds SCR only</td>
</tr>
<tr>
<td></td>
<td>DTAs / Future profits</td>
<td>Tier 3</td>
</tr>
<tr>
<td></td>
<td>Risk margin</td>
<td>Maximum of 15% (SCR only)</td>
</tr>
<tr>
<td></td>
<td>Best estimate liability</td>
<td>Technical provisions</td>
</tr>
</tbody>
</table>

---

\(^7\) 2009/138/EC

\(^8\) Under Solvency II, the regulatory capital of an insurer is called 'own funds'. However, the term "regulatory capital" is used in this paper. The requirements for the "tiers" of capital apply equally to insurance companies and the "regulated" EU holding company
Solvency II sets limits on the amount of Tier 1, Tier 2 and Tier 3 capital that can be held to cover an insurance company’s capital requirements, to ensure that the insurer has sufficient capital to absorb any losses that might arise. As with all companies, there is an optimum capital structure under which insurance companies aim to operate. Although more expensive than senior debt, regulatory debt instruments are significantly cheaper than equity. Using too much equity increases the overall cost of capital while using too much debt increases the risk profile of the business due to the obligation on the business to service the debt.

**Purpose of Capital Requirements under Solvency II**

The regulation of insurance companies is similar in principle to that of the banking sector. The solvency capital requirement of an insurer has the following purposes:

- To reduce the risk that an insurer would be unable to meet any claims;
- To reduce the losses suffered by policyholders in the event that a firm is unable to meet all claims fully;
- To provide an early warning to supervisors so that they can intervene promptly if an insurer's capital falls below the required level; and
- To promote confidence in the financial stability of the insurance sector.

Under Solvency II, there are two principle capital requirements of an insurer.

- The main capital requirement is the Solvency Capital Requirement ("SCR"). The SCR is the capital required to ensure that the (re)insurance company will be able to meet its obligations over the next 12 months with a probability of at least 99.5%. Should available capital fall below this threshold, supervisory intervention would be triggered to return the insurer to the appropriate capital level.
- In addition to the SCR capital, a Minimum Capital Requirement ("MCR") must be calculated which corresponds to an 85% probability of adequacy over a one year period. Should available capital fall below this threshold, supervisory intervention would be triggered to wind-up the insurer.

The limits for capital instruments covering the MCR are the most restrictive. The MCR must be made up of Tier 1 and Tier 2 capital only and at least 80% of the capital used to cover the MCR must be Tier 1 capital. For the SCR, at least 50% per cent of the capital making up the SCR must be Tier 1.

It is also expected that at least 80% of Tier 1 items should be “unrestricted” Tier 1; with no more than 20% being “restricted” Tier 1. Tier 2 can be up to 50% and Tier 3 can be no more than 15% of eligible capital. If the limit for one tier is exceeded, the item may still be capable of being counted in a lower tier (i.e. restricted tier 1 capital may count as Tier 2 capital if the 20% cap is reached).
In practice, (re)insurance companies will hold an additional capital “buffer” over and above the MCR and SCR for prudence (and this is generally required in practice by insurance regulators and the rating agencies). For supervisory purposes, the SCR and MCR act as regulatory triggers. The insurance regulator would intervene once the capital holding of the (re)insurance company (or holding company) falls below the SCR, with the intervention becoming progressively more intense as the amount of regulatory capital held approaches the MCR.

The Solvency II capital requirements apply equally to each active insurance company in a group of companies and also to the ultimate EU holding company of an insurance group. Each insurance entity and group holding company must hold sufficient regulatory capital which meets the Solvency II capital requirements. Where the parent company of a group of companies is located outside of the EU, the Solvency II requirements will apply to the “top” EU holding company.

The Solvency II Directive provides regional supervisors with a number of discretions to address breaches of the MCR, including the withdrawal of authorisation from selling new insurance business and, in extreme cases, the winding up of the company.

**Detailed requirements for regulatory capital instruments**

It is a requirement under Solvency II that all capital instruments should not:

- rank before policyholder or non-subordinated creditors on insolvency;
- include encumbrances or connected transactions (e.g. guarantees or reciprocal financing arrangements);
- pay distributions/coupons whilst in breach of the SCR; and
- be redeemed without prior approval by the insurance regulator.

Under Solvency II, regulatory capital instruments must be “loss absorbing” on an ongoing and/or on a winding up basis. The ability of an instrument to permanently absorb losses on a “going concern” basis or only in the event of a winding up (a “gone” concern) is key in determining which tier of capital an instrument will fall within. It is also a requirement that such instruments should not include terms which could cause or accelerate the insurer’s insolvency. The rules also have duration requirements which apply to each ‘tier’ of capital in order to satisfy the permanence requirements. In addition, insurers need to ensure that the duration of instruments is consistent with the duration of their liabilities. The detailed implications of these requirements for the tiers of capital are as follows:

**Tier 1**

Tier 1 capital instruments include ordinary share capital, non-cumulative preference shares and certain subordinated liabilities. All distributions on Tier 1 items must be cancelled in the event of a breach of the SCR and repayment of principal must be suspended. Preference shares and subordinated debt are subject to the ‘loss absorption’ requirement (described below) which could involve writing-off all amounts owed by the insurer to the holders of the instruments. Under
Solency II, “unrestricted” Tier 1 capital must make up at least 80% of total Tier 1 funds. Unrestricted Tier 1 will be made up of ordinary shares plus share premium. It will also include surplus funds meeting the full requirements for subordination and permanence.

“Restricted” Tier 1 items include paid in subordinated preference shares and certain subordinated liabilities. This type of capital is limited to a maximum of 20% of the Tier 1 capital of an insurer.

The 'Tier 1' loss absorption requirement applies where:

- where an insurer holds less than 75% of its SCR;
- where it breaches its MCR; or
- where it breaches its SCR for more than 3 months.

In these circumstances, there must be an automatic writing down of the liability of the insurer (principal and dividend/coupon), a conversion to ordinary shares or use of an 'equivalent mechanism' (i.e. similar to writing down or conversion).

**Tier 2**

Tier 2 'capital' is likely to include cumulative preference shares, and sub-ordinated liabilities with a shorter duration. Unlike Tier 1 instruments, the principal need not be written down or converted following a serious breach of the solvency requirements. Tier 2 may therefore also include shares or long term debt which does not comply with the loss absorption requirement described above. All distributions on Tier 2 shares must be suspended following a breach of the SCR whereas coupon and other amounts owing on debt and capital instruments must be cancelled. Therefore, debt to be included within Tier 2 can encompass both debt with hybrid characteristics (though of shorter duration that Tier 1 instruments) as well as other sub-ordinated liabilities.

**Tier 3**

Tier 3 capital is all capital items which do not satisfy the Tier 1 or Tier 2 requirements. Tier 3 items must have an original maturity of at least 3 years and need only suspend distributions (not interest/coupons on debt) on breach of the MCR (and not the SCR). However, breach of the SCR would still trigger a suspension of repayment of principal amounts. Certain net deferred tax assets also count towards Tier 3 capital.

**Incentives to redeem**

Tier 1 and Tier 2 capital can only be redeemed at the option of the insurer. Tier 1 items cannot include incentives to redeem. Tier 2 own funds may include 'limited' incentives to redeem provided this does not happen in the first 10 years. Tier 3 instruments can be redeemed by either party after 3 years. All redemptions, conversions and exchanges of all capital instruments require the prior approval of the supervisor.
Appendix II-

Reinsurance is a form of insurance coverage intended for insurance providers, and can be provided by other insurers or specialist reinsurers. Reinsurance business is subject to regulation in the same way that insurance business is, and can be provided by third parties or by other insurance group members. Policies can be of a number of types:

Facultative Coverage

This type of policy protects an insurance provider only for an individual, or specified risk, or contract. If there are several risks or contracts that needed to be reinsured, terms for each one must be negotiated separately, therefore this type of reinsurance is administratively intensive and tends to be used for single large risks. The reinsurer has the right to accept or deny a facultative reinsurance proposal.

Facultative coverage can be:

- **Proportional**: the reinsurer assumes a share of all claims relating to the risk, regardless of the amount, or
- **Non-proportional**: the reinsurer pays claims above a certain amount retained by the insurer.

**Example:**

An insured ship has a collision and makes a claim for 100m

| Type of Contract | Proportional: 40% cessation (i.e. reinsurer pays 40% of any claim, insurer pays 60%) | Non-proportional: Net retention of 20m (i.e. insurer retains 20m of any claim, reinsurer pays the remainder) |
Facultative coverage is often documented with a ‘cover note’ which sets out essential information such as the parties to the contract, the amounts and risks reinsured, and premium amounts. Apart from the cover note, the rest of the terms are often undocumented, and parties rely on common reinsurance custom and usage to govern the contract.

**Treaty coverage**

Unlike a facultative policy, which reinsures a single risk, a reinsurance treaty covers a variety of risks. Under a reinsurance treaty, an insurer must cede all risks that fall within the treaty, and a reinsurer must accept all ceded business. A treaty is generally set up for a year, and can cover a particular line of business (for example cargo) or cover a wider range (for example all aviation lines), or even cover the whole book of business an insurer writes in a year (called ‘whole account’).

Like facultative policies, reinsurance treaties can be proportional or non-proportional. There are a couple of well-known types of each:

- **Proportional-** where the reinsurer assumes a share of all claims relating to the risk, regardless of the amount. This can include
  - Quota share treaties, where the reinsurer takes a percentage of premiums (usually less a commission to the insurer) and pays the same percentage of claims
  - Surplus treaties, where the reinsurer takes a set amount of business written by the insurer in excess of what they wish to retain for themselves; premiums will vary by the level of risk inherent in the reinsured business (e.g. higher premiums for assumption of higher risks)

- **Non-proportional-** where the reinsurer pays claims above a certain amount retained by the insurer, the insurer can be certain about what its maximum losses can be. The insurer must pay a premium to the reinsurer even if no claims are made. These treaties can include
  - Excess of loss treaties, where the reinsurer pays claims in excess of those retained by the insurer on a particular line of business or a particular event
  - Stop loss treaties, where the reinsurer reimburses the insurer when an insurer’s overall losses reach a certain amount

---

**Example of an Excess of Loss (‘XL’) stack**
An insurer might purchase a ‘stack’ of XL treaties to cover losses (i.e. claims) from earthquake risk as illustrated below.

An insurer may do this to provide additional protection against very large losses and it is likely that purchasing a number of reinsurance policies with different levels of cover will be cheaper than purchasing a single reinsurance contract from one reinsurer. This is because a claim would only be made against Z if an unusually large loss arises and this low probability would be reflected in the premium pricing.

If earthquake claims are 2800, they will be paid as follows:

<table>
<thead>
<tr>
<th>Insurer pays</th>
<th>500</th>
</tr>
</thead>
<tbody>
<tr>
<td>X pays</td>
<td>500</td>
</tr>
<tr>
<td>Y pays</td>
<td>1000</td>
</tr>
<tr>
<td>Z pays</td>
<td>800</td>
</tr>
</tbody>
</table>
6 February 2015

By email to: transferpricing@oecd.org

Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
OECD

Dear Andrew,

BEPS Actions 8, 9 and 10: Discussion draft on revisions to chapter 1 of the transfer pricing guidelines (including risk, recharacterisation and special measures)

BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains

General comments

AFME\(^1\) and the BBA\(^2\) welcome the opportunity to respond to the OECD’s discussion drafts entitled “BEPS Actions 8, 9 and 10: Discussion draft on revisions to chapter 1 of the transfer pricing guidelines (including risk, recharacterisation and special measures)” and “BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains”.

---

\(^1\) The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

\(^2\) The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Our associate membership includes over 80 of the world’s leading financial and professional services organisations.
We wish to make clear that while AFME and the BBA have separate and distinct memberships, both organisations have decided to submit a single, combined response since our respective members share the same concerns with the OECD’s proposals in the discussion drafts.

We welcome that the OECD is consulting with business on its proposals. We believe that this approach is to the benefit of both policymakers and business and helps to avoid any unintended consequences arising from the OECD’s initial proposals. We believe that it is also valuable for the OECD to take account of the views of business on the practical aspects of operating the intended policy.

The relatively short time available to consider the discussion drafts – and the large number of other OECD discussion drafts recently open for consultation with short deadlines – poses a challenge for all businesses and the OECD secretariat. Should it be of assistance we would be pleased to meet with the OECD Secretariat to discuss these matters in greater detail or provide further information upon request.

**BEPS Actions 8, 9 and 10: Discussion draft on revisions to chapter 1 of the transfer pricing guidelines (including risk, recharacterisation and special measures) (the discussion draft)**

**The importance of regulatory capital and existing transfer pricing guidelines for banking and finance groups**

We note that the banking and financial services industry is subject to regulatory requirements, in particular with regard to capital, liquidity and leverage. We welcome the recognition in the discussion draft that the evolving regulatory environment in which banks and other financial institutions operate substantively differentiates them from other sectors for the purposes of action items 8 to 10.

Supervisory authorities have sought to ensure that the regulatory framework promotes financial stability, protects deposit holders and ensures the continuity of services to customers and businesses, in particular lending throughout the business cycle. This means that banks and other financial institutions are required to hold increased capital reserves against their assets and face limits on their ability to leverage. Critically, this also limits the ability of banks and other financial institutions to engage in activity which may cause concern in relation to BEPS.

The OECD has recently considered thoroughly the allocation of risk and capital within banking and financial services groups in developing the 22 July 2010 “Report on the attribution of profits to permanent establishments” (the 2010 report). We note that this report recognises the importance of Key Entrepreneurial Risk Taking (KERT) functions in a bank or financial institution (i.e., the creation of financial assets and management of
the risk associated with those assets). We believe that the 2010 report is widely regarded by both tax authorities and taxpayers as a reasonable and fair approach to taxing banking and finance businesses.

We would welcome clear recognition of the relevance of the 2010 report for the banking and financial services sector, and acknowledgement that it is consistent with the general approach outlined in the proposed revised Chapter 1, Section D of the Transfer Pricing Guidelines.

**Identifying commercial or financial relations**

We note that Part D.1 of the discussion draft provides new guidance for identifying the commercial and financial relations between associated enterprises. In particular, Paragraph 2 of the discussion draft states that the “process of identifying the commercial or financial relations between associated enterprises follows from examining contractual terms governing those relations together with the conduct of the parties. Establishing the conduct of the parties involves examination of all of the facts and circumstances surrounding how those enterprises interact with one another in their economic and commercial context to generate potential commercial value, how that interaction contributes to the rest of the value chain, and what the interaction involves in terms of the precise identification of the functions each party actually performs, the assets each party actually employs, and the risks each party actually assumes and manages.”

Whilst we believe that the process of identifying the commercial or financial relations between associated enterprises should focus on the conduct of the parties in addition to the contractual terms, we are concerned about a potential lack of consistency regarding the extent to which jurisdictions may take into consideration the conduct of the parties. We therefore welcome that Paragraphs 4 and 6 of the discussion draft include some examples suggesting how the conduct of the parties would be taken into account by tax authorities and we would encourage the OECD to include more examples. We would be happy to work with the OECD in due course in this regard.

As noted above, we would recommend acknowledgement of the established approach for banks and financial services. For the banking and financial services sector, we also recommend that the OECD guidance takes into account and stresses the importance of regulation as it affects both the contractual terms and conduct of the parties. The role of KERTs is directly relevant in this context and should be referred to in the OECD guidance.
Financial capacity to bear risk

We note that Paragraph 66 of the discussion draft provides that “Financial capacity to bear risk is a relevant but not determinative factor in considering whether a controlled party should be allocated a risk return. As stated in Chapter IX [of the July 2010 OECD transfer pricing guidelines], a high level of capitalisation by itself does not mean that the highly capitalised party carries risk (Paragraph 9.32). MNE groups, unless subject to capital adequacy regulations, can determine the capital structure of subsidiaries without explicit consideration of actual risk in that subsidiary.”

We note that Paragraph 66 of the discussion draft goes on to state that “For the same reason, a low level of capital in a controlled enterprise, should not prevent the allocation of risk to the company for transfer pricing purposes where such allocation is justified under the guidance of this Chapter”.

Again, we would note that the role of risk and capital has already been considered for the banking and financial services sector in the 2010 report. We believe that it would be helpful to cross refer to this work when developing any further proposals, in particular the interaction of the ability to assume risk and capital and the role of KERTs.

Non-recognition

We note that Paragraphs 83 to 93 of the discussion draft consider the issue of “non-recognition”, where transactions can be disregarded or recharacterised for transfer pricing purposes because the transactions do not have arm’s length attributes. Paragraph 86 of the discussion draft - in relation to the reason for the need for “non-recognition” – states that “except in certain regulated sectors, MNE groups have freedom to control their structures, including shareholding, capitalisation, and legal form.” We note that regulated banking and financial services groups do not have the freedom to structure their arrangements in the ways described in Paragraphs 85 to 87 as non-banking and financial services groups and we believe that this should be acknowledged explicitly in the guidance.

We note that Paragraph 93 of the discussion draft sets out the consequences of “non-recognition”. In particular, that the taxpayer’s structure may be replaced by an alternative structure that reflects the “fundamental economic attributes of arrangements between unrelated parties and that comports as closely as possible with the commercial reality of independent parties in similar circumstances”. We recommend that the OECD provides further guidance setting out how the alternative structure should be determined.
Special measures

Part 2 of the discussion draft presents five options for potential special measures to ensure that transfer pricing outcomes are in line with value creation. For options 2 to 5, the special measures seek to address issues arising from the “freedom that MNE groups have (except in certain regulated sectors) to control their structures, including the creation and capitalisation of companies”.

We think that it is correct to recognise that that the regulated environment for banks and financial services protects against such transactions, as we have briefly outlined in this consultation response. The further commentary on these aspects included in the AFME/BBA response on 6 February 2015 (attached for reference at Appendix 1) to the OECD’s 18 December 2014 discussion draft entitled “BEPS Action 4: Interest deduction and other financial payments” is also relevant.

For the reasons set out above, we suggest that if any of the options for special measures are developed further, care should be taken to ensure that they appropriately address the banking and financial services sector in a manner consistent with regulation and the 2010 report. In that regard, we believe that any general measure needs to take care not to cut across regulatory measures designed to promote financial stability and protect deposit holders.

We believe that any special measure should only be considered following the normal application of transfer pricing rules, which may well render the special measure unnecessary. We believe that the intention is for any special measure relating to capital to deal with a limited number of abusive situations and we would welcome this being explicitly stated. Any special measure which has a wider application is likely to also need a mechanism for eliminating double taxation. Our comments on the need for a corresponding adjustment included in the AFME/BBA response on 6 February 2015 (see Appendix 1) to the OECD’s 18 December 2014 discussion draft entitled “BEPS Action 4: Interest deduction and other financial payments” are relevant in this regard.

Paragraph 5 of Part 2 of the discussion draft acknowledges that “the situations addressed in this section have a close interaction with other actions under the BEPS action plan, including Action 3 on strengthening CFC rules and Action 4 on interest deductions”. We agree with that, and consider that measures to address over-capitalisation seem most naturally to be part of a CFC regime. If any of these options are developed further, future proposals will need to be coordinated with those developed under action items 3 (strengthening the CFC rules) and 4 (interest deductibility) to ensure that there are no duplicative special measures.
Consistency and dispute resolution procedures

We note that if the OECD does go ahead and develop the proposals associated with “non-recognition”, the “special measures”, or the focusing on the conduct between the parties with respect to identifying commercial or financial relations, it would be important to ensure that all jurisdictions adopt the proposals on a consistent basis to avoid double taxation and potential disputes between tax authorities. We would therefore encourage the OECD to provide as much clarity and guidance as possible. We would also stress the need for the development of appropriate dispute resolution mechanisms, currently being developed by the OECD under action item 14.

BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains

We also wish to take this opportunity to note the OECD’s proposals in its discussion draft entitled “BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains” (the discussion draft). The use of residual profit splits in the banking sector is well established, and has been the subject of considerable work at the OECD, including that included in the OECD’s 2010 report. Once again, we do not believe that the proposals in the discussion draft should interfere with the principles set out in the OECD’s 2010 report. We believe that the OECD’s output on action item 10 should therefore acknowledge the continuing relevance of the OECD’s 2010 report.

We are grateful for the opportunity to share our comments with the OECD on the discussion drafts and we would be happy to discuss any of the above in greater detail with the OECD and would be pleased to contribute further as the OECD’s work develops.

Yours sincerely,

Richard Middleton
Managing Director
Tax and Accounting Policy
AFME

Sarah Wulff-Cochrane
Director of Policy
Taxation
BBA
6 February 2015

By email to: interestdeductions@oecd.org

BEPS Action 4 Discussion draft: Interest deductions and other financial payments

AFME³ and the BBA⁴ welcome the opportunity to respond to the OECD’s discussion draft entitled: “BEPS action 4: Interest deductions and other financial payments” (the discussion draft). We wish to make clear that while AFME and the BBA have separate and distinct memberships, for the purposes of the discussion draft, both organisations have decided to submit a single, combined response since our respective members share the same concerns with respect to the proposals in the discussion draft.

We note that the relatively short time available to respond to the discussion draft – and the large number of other OECD discussion drafts currently open for comment – poses a challenge for all businesses and the OECD Secretariat. Should it be of assistance we would be pleased to meet with the OECD Secretariat to discuss these matters in greater detail or provide further information upon request.

Executive Summary

We support the OECD’s consultative approach on the development of these proposals. We believe that this will benefit both policymakers and business, by helping to reduce any unintended consequences arising from these proposals. We also believe that it is

³ The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

⁴ The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Our associate membership includes over 80 of the world’s leading financial and professional services organisations.
essential for the OECD to take account of the views of business on the practical aspects of operating the intended policy.

The discussion draft notes that measures based on gross interest expense would have distortive consequences. This is particularly relevant for the banking sector, where interest expense is effectively the equivalent of the cost of goods sold, and is closely linked to the cost of finance to the wider economy. We therefore agree that measures which consider net interest expense are a more accurate means of identifying and addressing BEPS concerns. We agree with the comment at Paragraph 209 which notes that because of the focus on net interest expense, banks will not be subject to a general limitation as they will be expected to generate net interest income. We would note, however, that the position of banks as net interest recipients should not be seen as indicative of base erosion in itself.

The banking sector - due to the evolving regulatory environment in which banks operate - is substantively different from other sectors for the purposes of this BEPS action. Banks are subject to strict regulatory requirements which, by a variety of measures, directly impact their capital structure, leverage and behaviour. We welcome the recognition of this distinction in the discussion draft.

Supervisory authorities and banks have sought to ensure that the regulatory framework promotes financial stability, protects deposit holders and ensures the continuity of services to customers and businesses, in particular lending throughout the business cycle. This means that banks are required to hold increased capital reserves against their assets and face limits on their ability to leverage. Critically, this also limits the ability of banks to engage in activity which may cause concern in relation to BEPS.

The discussion draft states at Paragraph 211 that consideration should be given to designing a rule which “limits a group’s net deductions on its regulatory capital to the interest expense paid on these instruments to third parties.” Paragraph 212 then states that targeted rules to address risks posed by specific transactions could be considered as an alternative. We would urge the OECD to first identify any remaining BEPS risks posed by banks. If such risks are determined to exist, we believe any measures taken to address them should be targeted rules that take fully into account and complement the evolving regulatory requirements banks face.

**Banking activity and the regulatory environment**

The business model of banks is built on borrowing from depositors or in the wholesale markets to provide lending to individuals, SMEs, larger corporates or governments at a margin over the cost of the funds to the bank. Banks may also buy or sell government debt and other securities to provide market liquidity to investors, and deploy their capital to enable their clients to hedge risk.

Regulation plays a critical role in determining how banks are able to carry out commercial activity to support the needs of their customers. Although banking has always been subject to significant regulation, the primary focus of policy makers since the financial crisis has been to improve the stability and resilience of the financial system, ensure deposit holders are adequately protected and support the continuity of
services to customers and businesses, in particular lending throughout the business cycle.

We believe that regulatory requirements on banks provide a significant restriction on their ability to undertake activity which may be considered to pose a BEPS risk from a number of perspectives.

i. Capital requirements

The key regulatory focus in recent years has been to strengthen the capital requirements placed on banks to reduce the probability of bank failures. Regulators have sought to ensure, via international standards such as Basel III, that banks have sufficient loss absorbing capital to withstand shocks to the financial system. This has led to a significant increase in the quantity and quality of banks’ capital. In Europe, these requirements apply to banks both at the group level and at the regulated subsidiary level, effectively requiring sufficient capital to be placed in customer facing operating entities.

In the context of BEPS, these capital requirements also act as a restriction on a bank’s ability to issue debt and push this down to subsidiaries as equity. This is because a bank subscribing for equity in a subsidiary is required to deduct that investment from its own capital when determining how much regulatory capital is eligible to be taken into account when calculating its capital adequacy. In other words, a bank which provides regulatory capital to a subsidiary reduces its own ability to undertake business, as its own capital base is reduced.

It is also worth highlighting that the capital requirements allow banks to meet a limited proportion of the minimum requirements through non-equity capital instruments. These instruments include Alternative Tier 1 capital (AT1), such as contingent convertible bonds, which have the characteristics of both debt and equity. However, we note that any BEPS risks posed by such instruments are specifically addressed by BEPS Action 2.

Paragraph 211 suggests the design of a group wide interest allocation rule which would limit a group’s total net deductions on its regulatory capital to the expense paid on these instruments to third parties. It is noted that regulatory capital provides core funding for a bank and an assumption that it plays a comparable role with debt in other sectors. We think that is a reasonable conclusion in the context of Action 4. The funds raised from regulatory capital are deployed in the business and generate profits in the course of the banks’ trade. Further, as noted above and unlike other sectors, banks’ ability to issue and redeem regulatory capital is subject to extensive and evolving regulation and regulatory approval.

ii. Large exposure limits

Banks are also subject to a regulatory large exposure limits. This rule limits any exposure, including those to a subsidiary, to 25% of capital net of any equity investment in subsidiaries and other undertakings. The large exposure constraint therefore places restrictions on banks’ ability to issue debt and push this down to subsidiaries as equity
as well as the use of intra-group loans from low taxed jurisdictions to high tax jurisdictions. In practice banks’ individual exposures do not come close to the 25% limit as this would give rise to concentration risk, which would prompt regulators to require banks to hold additional capital against that risk.

Some jurisdictions also impose domestic rules which further greatly limit BEPS activities for banks. For example, a US banking group would generally not be allowed to inject equity into an off-shore non-regulated entity.

iii. Commercial pressures

In addition to these regulatory pressures, banks’ activity is also influenced by their need to provide adequate returns for investors who have provided capital. Due to the nature of loss absorbing capital, investors expect greater returns than against other types of investment to reflect the potential risk of loss in the event of a default or write down. This creates a commercial pressure on banks to ensure they are not over capitalised and are earning sufficient return on their capital.

In addition to the regulatory constraints noted above, the ability of banks to borrow to fund equity investments is yet further constrained by external commercial pressures. This type of borrowing, or “double leverage”, is seen as a key consideration for investors and credit rating agencies when assessing the position of a bank. Double leverage is measured by inter alia calculating the ratio of equity issued to equity invested by a bank. If the ratio is considered excessive the holding company's credit rating may be reduced to reflect the perceived reliance on discretionary dividends to fund the interest obligations of the holding company, or its potential inability to realise its assets and repay its debt. The commercial pressure to retain a high credit rating therefore acts as a market incentive for banks not to undertake this type of activity.

These commercial pressures apply directly to banks' issuing entities (generally the parent or holding company) and this makes capital a valuable resource within a banking group. Once raised, the capital then has to be subscribed to the operating entities to meet local regulatory demands. In addition to the regulatory constraints, the focus on double leverage constrains a group’s ability to borrow to invest capital and means that capital needed by operating entities has to flow down from the issuers. Therefore there are strong commercial reasons for banks not to engage in activity which may pose a risk of BEPS.

Implications of regulatory requirements and commercial pressures for BEPS

These considerations, and the level of scrutiny employed by regulators and investors, mean that banks are over time unlikely to be significantly under or over capitalised, both externally and within the individual entities of a banking group. We believe that this significantly reduces the risk of potential BEPS activity being undertaken by banks through interest deductions and other financial payments.

Achieving BEPS through the use of interest deductions, which Action 4 addresses, requires the ability to freely structure borrowing, including the ability to terminate the borrowing easily. The adequacy and maintenance of a bank’s capital position is of
paramount importance and takes precedent over any discretion a bank might have to structure its borrowing in a manner which gives rise to potential BEPS concerns. Banks will also remain subject to significant regulatory scrutiny for the foreseeable future.

If there are specific BEPS concerns which the regulatory environment would permit and require further consideration, we believe these would be best addressed on a targeted basis with appropriate filters. For instance, we would only expect targeted rules to be contemplated when it has been clearly demonstrated that it would not be possible to address any concern using the arm’s length principle.

We would urge that any BEPS risks posed by banks be identified before determining if any further targeted measures are required. This will minimise the risk that any proposals would have unforeseen impact on groups’ regulatory positions and on the cost of finance to the wider economy. If such risks exist, we urge that any measures taken to address them be carefully targeted and take fully into account and support the evolving regulatory requirements banks face. We would be pleased to discuss this further with you.

**Specific issues raised by the Discussion Draft**

As noted above we fully support the net interest expense approach adopted in the discussion draft and believe that where BEPS risks are identified in the banking sector they should be only addressed by targeted measures.

As a general point we would note that the interest limitations introduced by many jurisdictions to date have provided measures which effectively exclude activity undertaken by banks, or banking groups, or otherwise ensure that the rules do not adversely affect the ordinary course funding of banks.

We would highlight how the approach taken by these jurisdictions recognises the policy drivers outlined elsewhere in this paper, not least the recognition that interest expense is the cost of sales for a bank and that such measures should operate without a detrimental effect on banks’ ability to lend and support economic activity. We believe that approach is appropriate and should continue to be a feature of any proposals or best practice suggested by the OECD.

Given the significant work that is being undertaken as part of the wider BEPS project, and the short time available to comment on the specific questions raised by the discussion draft, we would also make the following limited observations on the more general questions.

**Group Wide Test**

As business groups, such as the CBI, have noted the application of a group wide ratio on the basis of earnings or assets will inevitably lead to double taxation, unless that is directly addressed by a corresponding adjustment.

Whichever allocation factor is chosen (assets or earnings), their application will produce a difference between where net interest expense is incurred and the
jurisdictions to which the capacity to deduct the expense is allocated. The allocation factors in one jurisdiction in which a group operates will have an impact on every other jurisdiction in which the group is present.

Paragraph 80 notes “Groups may therefore seek to re-organise their intragroup financing to bring each entity’s ratio more in-line with that of the group, subject to any barriers preventing them from doing so”. In the context of banks this “self-help” approach would be particularly ineffective. The ability to locate borrowing to meet any tax ratio would firstly require the ability to predict the ratio for the year, which in itself is challenging for a risk-taking business. In addition to the substantive difficulties already identified by others, having predicted the location of the allocation, banks would also face regulatory barriers, as their ability to deploy and repay capital is subject to the approval of regulators who provide an additional level of oversight.

Fixed Ratio Test

As noted in Paragraph 158, fixed ratio tests have been developed and applied by a number of jurisdictions. When considering the merits of fixed ratio tests we would encourage the OECD to view this on a jurisdiction basis rather than an entity basis. If applicable, consideration should also be given to whether a higher ratio may need to be provided for banks in any proposals or suggested best practice given differences in bank funding compared to other businesses.

Combined Approach

The use of a combined approach has the capacity to resolve the difficulties of each model while still allowing BEPS risks to be addressed. Perhaps more significantly, it may also reduce the risk of double taxation presented by either approach in isolation. Conversely, we would be concerned if any combined approach were to in effect maintain the undesirable consequences of both approaches.

Careful consideration will therefore need to be given to ensure that any final rules are clear, predictable and do not create disproportionate compliance burdens for Tax Authorities and businesses.

Furthermore, if the OECD decides to adopt this approach it will also be important to ensure that any steps taken to address the banking sector are not invalidated by effectively introducing double hurdles.

Payments economically equivalent to interest.

The discussion draft identifies the difficulties that may arise from applying a best practice rule to items including those specified as payments economically equivalent to interest. We agree that there are likely to be practical issues in defining and extracting payments considered economically equivalent to interest when their treatment is likely to vary under different accounting standards.

One matter that could be problematic going forward is the intention to treat the equivalent of today’s finance leases and operating leases differently given the proposed
divergence of lessee accounting rules under IFRS and US GAAP. We note that the operating and finance lease terms will not be used but there will be a distinction on a similar basis.

The IFRS proposals would require lessees to treat all leases with periods over 12 months in the same way, reflecting a present value of the rentals in the balance sheet and charging a finance charge to the profit and loss account. There would be no distinction between different types of leases.

US GAAP would continue to distinguish between different types of lease and, broadly speaking, continue to charge the equivalent of operating lease rentals to the profit and loss account without separating out a finance charge.

The difference in accounting will either give inconsistent treatment between taxpayers using different GAAP if the finance charge in the accounts is used or practical difficulties for IFRS accounts users in splitting the accounts finance charge based on a split of lease type that is not relevant for the preparation of the accounts.

We would also suggest further consideration is required for the treatment of Sharia finance under any proposals.

**Double Taxation**

We believe that steps will be needed to ensure that the best practice approaches adopted by Action Plan 4 do not generate double taxation.

The discussion document accepts that the proposed approaches will deny deductions in excess of those needed solely to address BEPS. For instance, the suggestions at Part XII to allow for the carry forward of excessive deductions or capacity accept that there will be excessive restrictions.

Whilst we welcome any measures that prevent double taxation, we would urge the OECD to recommend more timely and comprehensive action to address the risk of double taxation. Any inability of corporates, including banks, to materially predict the tax treatment of debt will introduce uncertainty into investment and funding decisions.

We would therefore consider it of vital importance that the OECD sets out a mechanism which provides for clear and timely corresponding adjustments to be made where deductions are denied in any final proposals or best practice suggestions on the tax treatment of intra-group interest.

It is important to establish that a lender should not be taxed on intra-group interest income to the extent that the borrower is denied a deduction for the corresponding interest expense. In other words, there should be a coherent approach to the treatment of the lender and borrower to prevent double taxation, and this is particularly important given the proposals diverge from the arm’s length principle.

**Interaction with Other Actions**
We recognise that the Action Plans are being produced under intense time pressure and that each is being developed separately. The need for a cohesive response to BEPS is critical if the Action Plans are to be successful. As the discussion draft notes, Action 4 potentially overlaps with a number of the other BEPS Actions. We would therefore ask the OECD to undertake a review of how the recommendations within all the action plans interact in order to ensure there is a consistent and clear approach to BEPS recommendations affecting the intra-group provision of debt finance.

Yours sincerely,

Richard Middleton
Managing Director
Tax and Accounting Policy
AFME

Sarah Wulff-Cochrane
Director of Policy
Taxation
BBA
We respectfully submit comments on the Discussion Draft “Revisions to Chapter I of the transfer pricing guidelines” (dated 16 December 2014) (“the Draft”). If there is any specific point from our comments that you would like to discuss further, please do not hesitate to contact us.

As a general comment, we welcome this Draft as it is well written and timely. The Draft helps to make the link between some of the Chapters added to the OECD Guidelines in 2010, particularly Chapter 3 and Chapter 9, and the current Chapter 1, and clarifies and reinforces some points that - even though are not new - were often overlooked in practice.

In particular, the language in section D.1 about delineating transactions and the application of the comparability factors is clear and helpful. Since the Guidelines were changed in 2010, with a new Chapter 3 on “comparability analysis”, which is often used as a synonym of benchmarking in this Chapter 3, the wording on comparability on Chapter 1 had been overshadowed. This in itself, a full Chapter on comparability/benchmarking after the Chapter on methods (Chapter 2), placed the emphasis on "benchmarking" instead of on the first and more important step of identifying the relevant commercial transactions using the "comparability factors" explained in Chapter I, Section D.

A few specific comments to this section D.1:

Although we agree with the general idea presented in Pars 12, 13 and 14, we think it is important to mention that one of the reasons that multinationals ("MNC") exist is to reduce transaction-related costs. If, in applying the arm’s length principle, members of a MNC need to replicate all the steps that would occur in a third party negotiation (e.g., consider all options realistically available to the parties to the transaction, assume "complete information asymmetry" between the parties, draft contracts that would be similar in content/detail to third party contracts) and at the same time they need to take into account factors that are specific to the MNC operations (like diversification or the lack thereof, implicit support and to what extent it applies, synergies and who generates them and how they can be split, etc), the task may prove impossible to achieve.

We agree that applying the arm's length principle should not mean an automatic benchmarking exercise and a copy-paste of information from the annual accounts. We agree also that to be able to salvage the arm’s length principle we need to apply the principles provided by the OECD Guidelines more rigorously. However, if the exercise turns to be too complex, the reaction will be oversimplification. Also, MNCs will find themselves at a disadvantage vis-a-vis Small and Medium Size Enterprises ("SMEs") because MNCs will have a higher administrative burden than SMEs and arguably none of the benefits of being an SME (flexibility, less stringent labour laws, less infrastructure costs, lower governance and accounting requirements and costs, etc.).

There are a number of specific transactions in a MNC in which applying the arm’s length principle needs to be done with some degree of simplification, otherwise the exercise becomes too complex, and sometimes absurd, because the comparison to what independent parties would have agreed upon is just not possible. In particular:
a) the allocation of headquarter costs and applying the benefit test. Per definition, only MNCs have these type of costs so the comparison to what third parties would have agreed upon is very artificial.

b) similar to that, the concept of implicit support (either when calculating guarantee fees or in a similar situation). We could debate endlessly on whether a parent company will rescue a subsidiary if they were to default, and whether the answer would be different if the MNC was very centralized or not very centralized, or whether the subsidiary was core business to the MNC or not core business, etc.

The truth is that the answer is probably different in each case. Even for the same MNC the answer can be different in 2015 than it would have been in 2008, and they can even decide to rescue that particular subsidiary one time but not a second time (think of the situation between the EU and Greece at the time of writing these comments, 1st February 2015). There are just too many factors that play a role to decide if implicit support is high or low and what does it mean for the transfer prices of the group, not only for the granting of intercompany loans and guarantees but also for the sale of goods or any other intercompany transaction.

c) the sale of a business (or a part of a business) intercompany and how the price of the business (or individual assets) is calculated. There are many factors that are different in a third party situation than in an intercompany situation. One very simple example is that in a third party situation, the buyer performs a due diligence (which may more or less well carried out, very detailed or less depending on many factors) and uses some forecasts, which maybe similar or very different from those used by the seller (depending on the amount of information they have from the seller but also what is the buyer planning to do with the business).

Between third parties, the FMV of the business is only a starting point for the negotiation. The respective bargaining positions (with scarcity being an important factor) play a key role. In an intercompany situation, trying for instance to introduce the concept of the "bargaining position of the parties" and the "options realistically available" is theoretically possible and intellectually challenging, but in most situation leads to very subjective or at least not univocal results.

The same way that for allocating synergies that are not "the outcome of concerted action" (as mentioned in the revised Chapter 1, D.8. 19) we have arrived to a simplified consensus approach, that is, agreeing that they do not need to be allocated, for some of the most difficult transfer pricing questions like the ones mentioned above we may need a compromise/simplified solution otherwise applying the ideal arm's length principle will be impossible in practice.

When we apply the arm's length principle today to a straight-forward intercompany sale of goods we accept that an imperfect comparable it is better than no comparable at all. We also accept that if we apply the RPM or TNMM making the comparison to independent distributors of similar goods the comparison is not perfect because independent distributors are always smaller, may have a different business strategy, may face slightly different economic circumstances (e.g., there are many studies showing that MNC pay higher wages than SMEs). Yet, we accept the comparison.

Why are we then trying to apply higher standards (in terms of comparability and sophistication of the analysis) to more complex transactions like intangibles and transactions that do not happen often between third parties?
We understand that there could be situations where we should be discussing about mispricing, but this cannot be the general tone or assumption of the OECD Guidelines. The compliance burden cannot be the same for a company that is just trying to comply and establish a reasonable and actionable transfer pricing policy and for a company that is trying to play on the border lines. This needs to be clear in the OECD Guidelines because now too many chapters and examples depart from the assumption that the objective of MNEs is to manipulate the facts to arrive to a particular result.

Comments to Section D.2, D.3 and D.4:

We believe it is reasonable to assume that associated enterprises are acting collaboratively and, on a consolidated basis, do not have different risk preferences. As we mentioned above, the degree of collaboration and the extent to which different subsidiaries may have different risk preferences, depends, like the degree of implicit support on many factors: strategy of the group, organization (matrix, regional, product lines, centralized, decentralized, etc), management style, sector in which they operate, business model, country where the company originated from, country of operations, mode of expansion (organically, through acquisitions, mergers, etc.) even the culture of the MNC matters.

How do we take all these factors into account in a transfer pricing analysis? We simply will not be able to other than on a very limited and imprecise manner. We will need to agree on some simplifications to address this. Like the simplification to assume shareholder costs cannot be recharged, and the benefit of implicit support cannot be charged, and synergies do not need to be charged, safe harbours, etc.

On the issue of moral hazard, it is interesting to note that the OECD appears to look at principal-agency theory with a very selective view, when in fact the role of governance appears to be largely ignored, and emphasis placed on the "agents" (management and employees) and less so on the principals (whether that is the capital owner or the Board of Directors, etc.).

How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?

This point was addressed before in an earlier draft of Chapter 9, with the question about would third parties outsource or sell their "crown jewels". These paragraphs were dropped from the final version. The answer to this question is: it depends. It depends of the price a third party is willing to pay, it depends of the economic circumstances, it depends of the alternatives available. We see many examples in real life of companies that have divested their core business. Nokia, which started as a wood pulp manufacturing company, is a typical business book example. They moved from wood to telecommunications, to software to services. There are many other examples like this. Most recently, the leading manufacturer of fully electric cars, opened their patents to competitors to try to accelerate the move to electric car manufacturers. Also, if we look at the economic theory of clusters and how they develop and grow, we find many examples of cooperation versus competition between third parties. In other words, the strategy to protect certain intangible property or core competences is unique to each market player and it is not possible to try to replicate each possible option in an intragroup context.
3. In the example at paragraphs 90 and 91 how should moral hazard implications be taken into account under the arm's length principle?

It is very difficult to answer this question: if S1 and S2 where third parties would have they entered into this transaction? Again, there are many factors that play a role: is S2 able to extract more value from the trademark than S1? Are they expanding into new markets to which S2 has better access/knowledge etc. than S1? Has the trademark become a commodity in the market of S1 whereas it has potentially more value in other markets? The question we can answer is: is a lump sum payment of $400 M the right price for the trademark or would third parties have agreed to some milestone payments or a payment connected to the benefit S2 can derive from the trademark.

Risk-return trade off

Apologies but we run out of time to submit written comments to this section. We would be happy to discuss our views at the consultation meeting.

The last paragraph of this section mentions that "risk transfer is a core component of the financial services sector". This sentence holds true for many other sectors. In the professional services sector (audit and advisory) clients try to shift risk to their advisors, in the pharmaceutical sector companies try to share risk with governments and insurers, in the oil&gas sector companies try to shift risk to the government or future generations. We are all trying to transfer risks all the time.

We hope our comments above are useful. We would be happy to join the meetings 19-20 March to further discuss our comments above.

With kind regards

Ágata Uceda

Agata.uceda@alumni.insead.edu
Public Discussion Draft
BEPS ACTIONS 8, 9 AND 10

Contribution to Working Party No. 6 on the Taxation of Multinational Enterprises

ALESSIO ROMBOLOTTI AXELROD
2-5-2015
Mr. Hickman,

I welcome the opportunity provided by the OECD Transfer Pricing Unit and by Working Party No. 6 to comment over the revision to Section D of Chapter I of the Transfer Pricing Guidelines.

Contents

Foreword ..................................................................................................................................... 2

D.2 Identifying risks in commercial or financial relations .................................................. 3

Moral hazard ................................................................................................................................. 3

Risk-return trade-off .................................................................................................................... 4

Financial Services Sector ............................................................................................................. 7

D.2.1. The nature and sources of risk ....................................................................................... 8

D.2.3. How risks are assumed ................................................................................................. 8

D.2.4. Potential impact of risk ............................................................................................... 8

D.2.6. Actual conduct ............................................................................................................. 9

D.2.7. Transfer pricing consequences ..................................................................................... 9

Alessio Rombolotti Axelrod is an economic statistician who provides Risk Assessment &
Management services to multinational enterprises. Alessio is based in Milan, Italy, where
he teaches Statistics and Economics. You may access his recent publication at

Website averouge.com
E.mail Address alessio.rombolotti@averouge.com
Foreword

Before presenting my comments I’d like to make three remarks on Transfer Pricing practice and theory.

I. In Transfer Pricing practice risk is quite hard to assess and manage because very often it’s not measured in quantitative terms, often times functional and comparability analyses display risk merely as a qualitative factor whereas the key to effective risk estimation and management, at any level, is quantitative assessment.

II. If we follow the argument put foreward by the Arm’s Length Principle it’s easy to pick up an attitude which looks at multinational enterprises as sets of independent units. I believe that MNEs have, to some extent, different ways than independent firms and those ways, though not strictly complying with the AL Principle, may, nevertheless, be legitimate. Pooling of risks, sometimes, is one of those ways.

III. In a risk analysis framework my idea is that risk is strictly related to the assets, not to the functions performed. Besides the fact that with no assets no activity can be carried out, at least knowledge has got to be used, notice that we estimate the monetary value of assets, not of functions, and the assets’ value provide a quantitative benchmark against which risk can be compared and measured in monetary units. Clearly risk related to, say, inventories must be allocated with the inventories’ principals, in general risk should be allocated with the assets’ beneficiaries.

I’ve limited my contribution to Part I Section D2. My statements recall the paragraph number without reporting the original text, I suggest you read those comments after having read the original statement, instead when plain questions are being asked those very questions are reported (italics) along with my comments. Please be aware that for brevity reasons sometimes my comments focus on specific topics missing the greater picture but I didn’t want to extend my contribution beyond the ten page limit.

Thank you for your attention. I’m available for follow up remarks.

Alessio Rombolotti Axelrod
PART I

D.2 Identifying risks in commercial or financial relations

38. When performing comparability analyses more than the amount of risk assumed we’re primarily interested in knowing whether the tested party has, more or less, the same exposure to risk as its comparables. Risk is hard to assess by nature and by amount but it’s less hard to estimate whether two or more subjects have the same exposure to risk as a whole, i.e. credit risk + market risk + operational risk and so forth. For comparison purposes quantitative indices provide effective information, e.g. the ratio of the estimated standard deviation ($\sigma$) of the operating profit\(^1\), or cash flow, to its estimated mean ($\mu$) over 8/10 years, though a rough one, can be taken as a proxy of a party’s exposure to uncertainty as a whole and provides a less ambiguous information on uncertainty than any qualitative assessment. The implications of the moral hazard argument are examples of why we should rely on quantitative measures.

Moral hazard

1. Under the arm’s length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?

Moral Hazard and Conflict of Interest can both be used as qualitative tests for non-arm’s length transactions. They can be used in such a fashion since moral hazard and conflict of interest are not present in negotiations between unrelated parties, hence for any controlled transaction in which moral hazard or conflict of interest are present the risk of arm’s length non-compliance may be significant. For example if all intercompany purchases go through the group’s head-buyer then risk of arm’s length non-compliance is significant prior to any further consideration and those transactions should be investigated. The idea is that independent negotiations and independent transactions, besides being

\(^1\) To be intended as the operating profit from intercompany transactions over some appropriate timeframe so to lay off any periodicity effect.
carried out at market price, display standard characters, hence whenever controlled negotiations and transactions lack those characters then risk of being outside the arm’s length range may be significant. Absence of Moral Hazard and Conflict of Interest are two of those characters.

2. **How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?**

Confidential information should be assumed unavailable to outsiders and any framework used by outsiders to assess risk should be based on qualitative and mostly quantitative observable data.

3. **In the example at paragraphs 90 and 91 how should moral hazard implications be taken into account under the arm’s length principle?**

Since S1’s only asset generating cash flows is the trademark, buying that asset is the same as buying the whole firm. Hence, either those 400 $ mln include the present value of the cash flows to equity that will be generated by S1 after the sale of the trademark or the price paid by S2 is below the fair price. As to moral hazard if we put the transaction to the test it appears that S1 may cause a great damage by mismanaging the trademark and the related functions but its risk is limited to the net present value of the royalties lost. Hence risk of being outside the arm’s length range is present.

**Risk-return trade-off**

4. **Under the arm’s length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognised, how should they be treated?**

Usually we expect a transaction to be an exchange of economic goods and services between two parties and if the sole effect of the transaction is shifting risk, i.e. no economic value is being transferred along with it, then in principle
it’s not an arm’s length transaction. Anyway suppose an American MNE\(^2\) buying euro denominated raw materials from a European supplier for its American asset; the American asset (or associate) provides also goods to its Chinese subsidiary which in turn sells its output into the European markets. In order to lay off exchange rate risk the American associate has the Chinese subsidiary buying those raw materials which eventually are sold at par value to the Americans. The rationale for this transaction is based on the revenues generated by the Chinese subsidiary in Europe and its capacity to offset the exchange rate risk arising from purchases in euros.

This is an example of a non-arm’s length transaction, since no one would take on risk for free, but in this case it may be argued that it’s a legitimate operation since the Chinese subsidiary can offset the Euro/USD exchange rate risk at no cost. Notice that the same result can be attained with a swap agreement between the Americans and the Chinese where if the value of the euro increased with respect to the dollar then the Chinese would pay the difference to the American associate, if the the euro devalued then the Americans would pay the difference to the Chinese subsidiary. If I’m not mistaken in the Guidelines swaps are mentioned within the financial derivatives sections but it should be clear that some transactions within the MNE may, in fact, be swaps. Those kind of transactions should be recognized and addressed by the OECD Transfer Pricing Guidelines and by the Financial Administration departments of the OECD member countries.

5. In the example at paragraphs 90 and 91, how does the asset transfer alter the risks assumed by the two associated enterprises under the arm’s length principle?

Following the rationale that risk is related to assets\(^3\) (tangibles and intangibles) S1 has transferred its risk attached to the trademark to S2 and such risk should have been reflected by the discount rate chosen to evaluate the trademark’s value. On the other hand, by signing the service agreement, S1 has took on risk attached to its marketing knowledge, which is now the asset generating service fees. The point is that S1’s risk is completely dependent upon the trademark,

---

\(^2\) Multinational Enterprise.

\(^3\) I.e. no assets no risk and each asset carries some risk, which sometimes is zero, e.g. when the asset is cash.
hence both parties are now exposed to the same risk. Such transactions are likely to be performed arm in arm since when the original owner of the asset gives up ownership it’s in her or his interest to give up the risk attached as well.

6. **In the example at paragraphs 90 and 91, how should risk-return trade-off implications be taken into account under the arm’s length principle?**

In paragraph 90 and 91 the result of the transaction for S1 is to have given up its asset’s cash flows but not the related risk. The question is whether the price paid by S2 is fair. If we agree that S1 should have given up both the asset and the related risk, given that S1 keeps its exposure to risk after the transaction then from the point of view of S1 the fair price includes the amount of risk it will assume after the sale of the trademark. Clearly from the point of view of S2 this argument doesn’t hold, S1’s fair price is not an arm’s length price from S2’s point of view.

Again, the bottom line is that in an arm’s length transaction the asset is transferred along with its risk, the seller doesn’t remain exposed to the asset’s risk.

7. **Under the arm’s length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk? If so:**

   a) **Are there limits to the extent that the risk-return trade-off should be applied?**

   For example, can the risk-return trade-off be applied opportunistically in practice to support transactions that result in BEPS (for example by manipulating the discount rates to “prove” that the transaction is economically rational)?

   The risk-return trade off does not apply in general. When we buy an asset its risk on a stand alone basis is not equal to the amount of risk we assume. The amount of risk contributed by the new asset depends on the correlation between its cash flows and all the cash flows generated by the assets already in our portfolio, hence if the correletion is negative the this new asset, even if quite risky on its own, causes a reduction of our exposure to risk.

   For instance, cash flows provided by a very risky asset for party A, thus requiring a high return, may be negatively correlated to the cash flows of party B’s assets,
in fact serving as a hedge, therefore reducing the overall risk which party B is exposed to, thus party B may accept a much lower return than party A.

b) **Are there measures that can be taken in relation to the risk-return trade-off issue to ensure appropriate policy outcomes (including the avoidance of BEPS) within the arm’s length principle, or falling outside the arm’s length principle?**

There are quantitative measures of risk-return trade-off. By taking standard deviation as a proxy for uncertainty and return on assets, return on tangible assets or return on sales for trading operations, we can set up a rough index to measure risk-return trade-off.

If we want a more sophisticated measure we can model risk-return trade-off as a function that puts present value in relationship with risk and returns and the parameters of the function can be estimated and benchmarked, although we’d need to assume that “The subjects included in the benchmarking sample have, more or less, the same attitude toward risk aversion”.

Anyway I doubt that a general market measure for risk-return trade-off can be adopted for the argument presented above, a very risky asset for some is a hedge and, on the other hand, a safe asset may increase our overall exposure to risk.

**Financial Services Sector**

8. **Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?**

They apply to the financial services also and from this point of view are easier to assess than industrial corporations because risk, by being a key component of the products traded, can usually be benchmarked. Two assets of the same nature and providing the same cash flow must have, more or less, the same price when they both carry the same risk, if risk differ then they are no longer comparable, at least prior to some adjustment. In the financial sector risk affects the comparability of products. Also in the financial sector we may find very special products which are very hard to evaluate because there is no deep market, or no
market at all, but again I think financial services, as to risk, can be included in a general transfer pricing framework.

D.2.1. The nature and sources of risk

42. In paragraph 42 it is stated that “Risks which are vaguely described or undifferentiated will not serve the purposes of a transfer pricing analysis” and I do agree but for sake of practical application we shall differentiate between measurable and non-measurable risks, only measurable risks, at least qualitatively, can be included in practical frameworks.

D.2.3. How risks are assumed

46. The transaction between S1 and S2 is not carried out at arm’s length unless the transfer price is set in advance by referring to some independent parameter. In the example depicted, where the transfer price depends upon S2’s sales price, S2 might grant large discounts to its customers because the purchase price will be adjusted to the new price level and that’s a situation which very unlikely may happen between independent subjects.

D.2.4. Potential impact of risk

49. If the party performing commercial activities is insulated from product risk then it should be clear that in specific cases it’s free to buy from other suppliers. As a matter of fact independent distributors are always very careful over this issue and usually contracts report specific provisions in regard to it.

53. In the examples reported in 51 and 52 I don’t see violations of the arm’s length principle. Notice that in both cases we’re relating risk to functions, not to assets. The point I want to make is that in both cases there’s not a moral hazard or a conflict of interests issue, interests are aligned, the Parent company may be a stronger negotiator than its distributors on their own with respect to either cost of funding and business conditions. It’s true that usually independent distributors are less competitive than MNE’s subsidiaries because parent companies provide better financing and business conditions. What’s important is that risk management, funding, negotiating and marketing activities performed by the Parent company be paid by the subsidiaries.
D.2.6. Actual conduct

63. We might say that risk is borne by the party entitled to receive the value produced by the asset. In the example in case of an equipment breakdown the outsourced risk manager may lose a customer but the owner of the asset loses all the cash flows, hence I wouldn’t say that she or he are not exposed to the risk and should not be rewarded for that, even though the owner doesn’t perform risk management functions. For instance if I buy shares of a firm’s equity listed in a stock exchange I don’t have the capability to control and manage the firm’s risk but nevertheless I expect my return to include the risk premium on that stock. I wouldn’t make an exception for related parties. This is a subtle matter because in the end any risk assumed by any group’s associate is borne, to some extent, by all and by the whole and if this is true then the Parent company and all the associates may claim a risk reward, even though they are not directly exposed to that risk.

65. As in paragraph 63, since the investor is actually exposed to risk by being the beneficiary of the asset's cash flows then the same is entitled to the risk reward, or risk premium. Notice that risk premia expected by capital providers are aligned with value creation centres. On the other hand the risk manager will be rewarded for the service provided.

71. As I’ve stated above the value of the same risk changes from party to party with respect to the risk’s correlation with the parties’ cash flows and that’s the chief reason for not relying on a risk-return trade-off market benchmark, at least as a general rule.

D.2.7. Transfer pricing consequences

75. We must realize that some information is very hard to retrieve and many times in comparability analyses we can only make assumptions as to risk exposures of comparable parties.
February 6, 2015

Andrew Hickman  
Head, Transfer Pricing Unit  
OECD/CTPA  
2, rue André Pascal  
75775 Paris Cedex 16  
France

Re: Discussion Draft: BEPS Actions 8, 9 and 10  
Risk, Recharacterization and Special Measures

Dear Mr. Hickman:

Introduction

Thank you for the opportunity to submit comments to the OECD with respect the above-referenced discussion draft.

The below-named signatories are leaders of the global transfer pricing practice of AlixPartners LLP. AlixPartners is a well-established global business advisory firm. We are the trusted advisors to corporate boards and management, law firms, investment banks, investors, and others who value objective advice, critical insight and actionable expertise.

The comments and opinions offered here are our own and do not necessarily represent those of AlixPartners.

To facilitate review of critical issues presented by the discussion draft, we have organized our comments to address key subject matter areas rather than individual paragraphs contained within Part I of the draft. We are also providing comments with respect to several of the proposed special measures as described in Part II. Finally, we will present our comments in the context of the transfer pricing regulatory framework and experience of the United States.

Comments

1. Risk and the Arm’s Length Standard

The United States has a well-defined regulatory framework with respect to both comparability standards and adjustments to improve reliability of results. When examining related party transactions, U.S. transfer pricing regulations reflect that generally a determination as to whether the controlled transactions are consistent with the arm’s length standard is made by comparing the results to those “realized by uncontrolled taxpayers engaged in comparable transactions under comparable
circumstances.” The regulations then identify five factors that need to be considered in that analysis: functions, contractual terms, risks, economic conditions and, finally, property or services. In reviewing potential third party benchmarks, the regulations further describe the types of risks that need to be taken into account, including market risks, research and development risks, financial risks, credit and collection risks, product liability risks, and general business risks.

The U.S. regulations further indicate that it is necessary to compare the “significant contractual terms” and, where there is no written agreement, to consider the economic substance of the transaction, giving greatest weight “to the actual conduct of the parties...”

We note that the U.S. regulations reflect very clearly that it is necessary to consider a number of factors to determine whether related party behavior is consistent with the arm’s length principle. To be sure, the guidance proposed in this discussion draft begins by noting that a “comparability analysis is at the heart of the application of the arm’s length principle,” including consideration of “all the facts and circumstances” (discussion draft, para. 2). We further recognize that the principle focus of this discussion draft is on risk and inappropriate transfer of risk that would result in base erosion and profit shifting. The discussion draft pays particular attention to the extent to which contractual provisions in intercompany agreements that transfer risk are properly aligned with value creation. However, we believe that the OECD should indicate that risk is but one of the factors that need to be considered in determining whether controlled transactions are consistent with the arm’s length principle.

Additionally, after a comparability analysis has been completed (that includes risk considerations), the taxpayer is faced with the question of whether, and the extent to which, adjustments can be made to improve the reliability of the results, consistent with the arm’s length standard.

This OECD discussion draft is focused, as one would expect, on risk considerations in the context of base erosion and profit shifting. However, it is important to provide some guidance with respect to threshold determinations by taxpayers and tax authorities with respect to risk. Therefore, we propose that the OECD provide guidance that indicates, consistent with the approach taken by the United States, that consideration of risk is a two-step process. First, risk should be one of several qualitative factors taken into account in the selection of potential comparables. And second, once a determination is made that the difference in risk between the transactions being evaluated and that of third party benchmarks is material, that a quantitative mechanism be in place that allows, where possible, for adjustment to the tested party results to diminish the impact of risk such that the result ultimately is determined to be

---

1 Treas. Reg. sec. 1.482-1(d)(1).
2 Ibid.
4 Treas. Reg. sec. 1.482-1(d)(3)(ii)(1) and (2).
5 In addition to the general considerations contained in sec. 1.482-1 of the regulations, other sections of the U.S. transfer pricing regulations have specific guidance with respect to intangibles, which is a major focus of this discussion draft. See, e.g., sec. 1-482-4 (re intangibles generally) and 1.482-7 (re cost sharing agreements).
reliable. Finally, we also propose that a simple presumptive test be put in place to address the OECD’s concerns about BEPS in the context of risk. We provide further thoughts regarding these matters in section 3 below.

2. **Paragraphs 90 - 92**

Paragraph 90 of the discussion draft lays out a scenario in which an affiliate transfers a valuable intangible to another affiliate in a low-tax jurisdiction in exchange for a lump sum payment, after which a royalty is paid to the new owner for use of the intangible, but for which the new owner also pays the prior owner for services. Paragraph 91 lays out several factors, which lead to the conclusion in paragraph 92 that “the transaction lacks the fundamental economic attributes of arrangements between unrelated parties.” The inference in this example is that such transactions lack economic substance because parties at arm’s length would never enter into such transactions.

We fundamentally disagree with this premise. Using the same facts as in the example, but expanding upon them with others, we can create a scenario in which parties at arm’s length could indeed enter into a series of transactions like that described in paragraph 90. The party acquiring the intangible may be in the business of financing; the party transferring the intangible may have an immediate need for substantial cash. In exchange for the implicit financing, the parties agree to a royalty arrangement to provide, in part, a market return on the investment. Since the acquirer is in the business of financing only, it needs to protect its investment and therefore enters in an arrangement with the transferor to maintain and enhance the value of the intangible. The payment made by the acquirer for those services is factored into the royalty arrangement so that the acquirer is made whole for those costs.

This example illustrates the importance of fully developing all the facts before drawing an inference as to how parties might behave at arm’s length.

3. **An Alternative Approach to BEPS and Risk Issues**

We believe that, if implemented by domestic tax authorities, the overall tone and tenor of this discussion draft will lead to the addition of unnecessary layers of complication for both taxpayers and tax authorities. We fully understand and share the concerns about inappropriate transfer pricing resulting from misapplication of basic economic principles. We offer here a straightforward, 3-step approach that would provide both taxpayers and tax authorities with sufficient guidance to produce a workable approach to consideration of risk-related issues.

*Step 1:* Review all factors affecting the controlled transactions. Risk considerations are important, but there are other equally important factors that need to be considered in the totality of circumstances. If the behavior of the parties to the controlled transaction is consistent with arm’s length behavior, and no adjustments are required to account for risk, the inquiry is ended.
Step 2: If risk factors are considered to be material to the analysis, and substantive differences exist between controlled and uncontrolled transactions, determine whether or not sufficient reliability can be achieved through adjustments. Admittedly, this is an area of some subjectivity. However, in our experience, it has been possible in certain situations to make adjustments that take risk into account. For example, a controlled transaction involving a limited risk distributor may be tested using comparable results from full distributor benchmarks, but by setting the limited risk distributor return at a lower point in the arm’s length range. Conversely, if a distributor takes on greater inventory risk than third party comparables, for example, provide a supplemental return that reflects that risk.

Step 3. In transactions where BEPS is a consideration, we urge the OECD to establish a simple mechanism that will provide much-needed guidance. We are mindful of the fact that the objective of this exercise is to eliminate BEPS, so let’s start with situations which, from a tax authority perspective, are inherently worth closer scrutiny. We encourage the OECD to set a marginal corporate tax rate benchmark, below which transactions could be subject to further review. Alternatively, the OECD could develop a list of jurisdictions which are, due to unusually low marginal corporate tax rates, considered to be “tax havens.” In these situations, the taxpayer would need to establish the economic substance of the related party transactions. Having transactions with affiliates in low-tax jurisdictions does not mean ipso facto that the transactions are suspect or necessarily not arm’s length. It simply means that the taxpayer needs to establish and fully support the arm’s length nature of those transactions, optimally through a robust ex ante analysis.

4. Selected Special Measures Comments

Option 1 relates to development of possible additional or special measures related to the transfers of hard-to-value intangibles. Conceptually, the approach taken is similar to that found in section 1.482-4(f)(2) of the U.S. transfer pricing regulations. We believe the approach taken in the U.S. regulations sets an appropriate roadmap for this issue, particularly with respect to operation within the regulations of the so-called “periodic adjustment” rule. Under U.S. regulations, where a taxpayer’s actual annual results from exploitation of an intangible are within, on a cumulative basis, a range of 80% to 120% of the forecast results, a safe harbor is provided and no adjustment is made, assuming other requirements of the regulations are met. Further, once the taxpayer has met the requirements of the regulations for the first five years, no periodic adjustment is required for any subsequent year. We believe this is a workable approach to address concerns about “systematic mispricing” of intangibles reflected in this option.

We also note that, although this potential special measure implicitly deals with perceived misallocations of profits, there should be symmetry in terms of how losses as well as profits are treated. There are situations where, due to unanticipated circumstances, a substantial loss is the result of exploitation of the intangible, rather than profit. In some cases, that loss could have value in offsetting profits. We

would like clarification regarding the application of this special measure, if adopted, to issues involving allocation of losses.

**Option 4** suggests consideration of a targeted special measure related to situations where functionality is perceived to be lacking, which could result in a reallocation of profits by a tax administration. This option lists possible qualitative and quantitative attributes that would trigger a reallocation based upon perceived functionality inconsistent with the level of profitability.

We are concerned that the attributes listed here, if reflected in the domestic transfer pricing regulations of any country, may inadvertently trigger an unintended BEPS consequence. In particular, by definition, related parties usually receive a “substantial part of the company’s income from arrangements with group companies.” Further, captive distributors – including many of our clients – often perform “routine functions” with a “small number of employees.” These criteria alone should not bring about a BEPS-driven inquiry that could result in reallocation of profits (or losses) to the parent or another affiliate. We are confident this is not the intention of this proposed special measure, but we strongly encourage the OECD to make it clear that this option, if adopted, does not apply to routine multinational arrangements. Perhaps the OECD could consider the same criteria described in our section 3 above to ensure only perceived BEPS situations are within the purview of such a special measure.

Thank you for your consideration of our comments. Of course, please feel free to contact us should you have any questions.

Regards,

Steven D. Felgran  
Co-Director, North American Transfer Pricing

Steven D. Harris  
Co-Director, North American Transfer Pricing

Nobuo Mori, Managing Director  
AlixPartners LLP
January 29, 2015

Amir Pichhadze
Email: amir@pichhadze.com or aplaw@umich.edu

Attention: Andrew Hickman
Head of Transfer Pricing Unit
Center for Tax Policy and Administration
OECD

Re: The roles of contract interpretation law and private international law in the transfer pricing arm’s length comparability analysis

This is a comment by Amir Pichhadze on the “BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines – December 1, 2014 to February 6, 2015” (the “Discussion Draft”). The comment is based on Pichhadze’s analysis in two papers which are forthcoming in the IBFD’s World Tax Journal (2015, Vo.7, No.1) and the International Transfer Pricing Journal (May/June 2015, Vol.22).

TABLE OF CONTENTS
1 THE TASK OF DELINEATING THE ACTUAL CONTROLLED TRANSACTION IN THE TRANSFER PRICING ANALYSIS .......................................................................................................................... 2
  1.1 THE ARM’S LENGTH COMPARABILITY ANALYSIS: AN OVERVIEW .......................................................... 2
    1.1.1 Stage 1: Ascertaining the taxpayer’s circumstances and the true nature of the actual controlled transaction .......................................................................................................................................................................................... 2
    1.1.2 Stage 2: Searching for a comparable uncontrolled transaction .......................................................................................................................... 3
    1.1.3 Stage 3: Applying an appropriate transfer pricing method to value the ‘price’ or ‘profit margin’ .... 4
    1.1.4 Stage 4: Testing the transfer price ........................................................................................................... 5
  1.2 A CLOSER LOOK AT STAGE 1: THE TASK OF DELINEATING THE CONTRACTUAL TERMS OF THE ACTUAL CONTROLLED TRANSACTION .......................................................................................................................... 5
2 THE ROLES OF ‘CONTRACT LAW’ AND ‘PRIVATE INTERNATIONAL LAW’ IN THIS ANALYSIS .......................................................................................................................... 6
3 IMPLICATIONS OF HAVING TO CONSTRUE THE CONTRACTUAL TERMS .......................................................................................................................... 7
  3.1 THE SEARCH FOR A RELIABLE ARM’S LENGTH COMPARABLE NECESSARILY DEPENDS ON HAVING A PROPERLY CONSTRUED CONTROLLED TRANSACTION .......................................................................................................................... 7
  3.2 FAILURE TO PROPERLY IDENTIFY AND INTERPRET THE TERMS RISKS MAKING AN ERROR UNDER DOMESTIC LAW .......................................................................................................................................................................................... 8
  3.3 THE POTENTIAL APPLICATION OF DIFFERENT SOURCES OF CONTRACT LAW COULD CREATE THE INCENTIVES AND OPPORTUNITIES FOR LEGAL ARBITRAGE, WHICH IN TURN COULD FACILITATE TRANSFER PRICING SCHEMES .... 10
4 CONCLUSION AND PROPOSAL FOR REFORM .......................................................................................................................... 11
1 The task of delineating the actual controlled transaction in the transfer pricing analysis

1.1 The arm’s length comparability analysis: an overview

Domestic transfer pricing rules around the world are based on the Arm’s Length Standard (“ALS”). This standard is typically also set out in bilateral tax treaties, based on Article 9 of the Model Tax Treaties.2

The ALS requires testing the income allocation result in a controlled (non-arm’s length) cross-border transaction based on an arm’s length income allocation result, as evidenced by comparable uncontrolled transaction(s). Guidance on how to carry out this comparability analysis is not typically set out in the domestic legislation or the bilateral tax treaties. Instead, most countries typically follow, to varying extents,3 the OECD’s Transfer Pricing Guidelines (“TPG”);4 whereas in the US the analysis is carried out in accordance with the IRS Treasury Regulations (“US regulations”) to §482 of the Internal Revenue Code. Based on the TPG and the US regulations,5 it is possible and convenient to describe this analysis as involving the following four stages.

1.1.1 Stage 1: Ascertaining the taxpayer’s circumstances and the true nature of the actual controlled transaction

In the first stage, it is necessary to conduct a broad-based analysis of the taxpayer’s circumstances6 and to delineate the true nature of the actual controlled transaction under review.7 Delineating the controlled transaction requires identifying the ‘commercial and financial relations’ between the related parties. More specifically, the TPG and US regulations focus on

---

2 The model tax treaties include: the OECD’s Model Convention on Income and on Capital, which focuses on treaties between developed countries; the UN’s Model Double Taxation Convention between Developed and Developing Countries; and the US’s Model Income Tax Convention. Each of these models contains an Article 9, which deals with associated enterprises and sets out the ALS. As the American Internal Revenue Service noted in its Notice 88-123, the OECD, UN, and US Models are essentially the same with respect to Article 9 (U.S. Department of the Treasury, “A Study of Intercompany Pricing” (Oct. 19, 1988), Notice 88-123, 1988-2 CB 458, 475)


6 This analysis would consider “the industry, competition, economic and regulatory factors and other elements that affect the taxpayer and its environment, but not yet within the context of looking at the specific transactions in question.” (Ibid, at para 3.7)

identifying the “fundamental economic attributes”\(^8\) [also referred to as “comparability factors”\(^9\), “economically relevant characteristics”\(^10\), “conditions”, among other expressions] of these ‘commercial and financial relations’. These factors/attributes/characteristics/conditions (“comparability factors”) include: “the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties.”\(^11\)

Why do these factors form the basis of the comparison? It is presumed that when arm’s length parties make their decisions about whether to enter into a commercial or financial relation (i.e. a transaction), they consider the alternative options available to them in light of these factors, and “they will only enter into the transaction if they see no alternative that offers a better opportunity to meet their commercial objectives.”\(^12\) “For instance, before purchasing a product at a given price, independent enterprises normally would be expected to consider whether they could buy the same product on otherwise comparable terms and conditions but at a lower price from another party.”\(^13\)

1.1.2 Stage 2: Searching for a comparable uncontrolled transaction

The second stage involves finding ‘internal’\(^14\) or ‘external’\(^15\) transactions that are comparable to the actual controlled transaction and the taxpayer’s circumstances. “[T]he comparability analysis always aims at finding the most reliable comparables. Thus, where it is possible to determine that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated.”\(^16\) “To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.”\(^17\)

\(^8\) OECD (July 2010), supra n.4, at paras 1.36-1.53; OECD (Dec 2014), ibid at para 83; IRS Treasury Regulations, §1.482-1(d)(1)
\(^9\) OECD (July 2010), supra n.4, at paras 1.36, 1.38-1.63
\(^10\) OECD (July 2010), supra n.4, at para 1.33
\(^11\) OECD (July 2010), supra n.4, at para 1.36
\(^12\) OECD (Dec 2014), supra n.7, at page 7, para 12
\(^13\) OECD (July 2010), supra n.4, at para 1.35
\(^14\) An ‘internal’ comparable is a “transaction between one party to the controlled transaction and an independent party.” (OECD (July 2010), supra n.4, at paras 3.24, 3.27-28)
\(^15\) An ‘external’ comparable is a transaction “between two independent enterprises, neither of which is a party to the controlled transaction.” (OECD (July 2010), supra n.4, at paras 3.24, 3.29-3.36)
\(^16\) OECD (July 2010), supra n.4, para 3.2
\(^17\) OECD (July 2010), supra n.4, at para 1.33. IRS Treasury Regulations, §1.482-1(d)(2). Regarding the option of conducting comparability adjustments, these are adjustments “made to the conditions of the uncontrolled transaction in order to eliminate the effects of material differences which exist between them and the controlled transaction.” (OECD (22 July 2010), Comparability Adjustments, OECD Publishing, Paris, para 3. Retrieved from: http://www.oecd.org/tax/transfer-pricing/45765363.pdf) Note that such adjustments would only be appropriate if the difference being corrected would have “a material effect on the comparison,” (OECD (July 2010), supra n.4, at para 3.51) and the adjustment would improve the reliability of the comparability analysis (OECD (July 2010), supra n.4, at para 3.50). Also, “the need to perform numerous or substantial adjustments to key comparability factors may indicate that the third party transactions are in fact not sufficiently comparable.” (OECD (July 2010), supra n.4, at para 3.51)
It should be emphasized that in searching for comparables, the key question is “not whether the same transaction can be observed between independent parties,” but rather “whether the actual transaction possesses the fundamental economic attributes of arrangements between unrelated parties.”

This search for a comparable may reveal that the fundamental underlying basis of the arrangement in the actual controlled transaction [i.e. the transaction’s comparability factors] cannot be found in an arm’s length transaction, because parties trading at arm’s length would not have entered into an arrangement that possesses such factors. In such a case, it would not be appropriate to rely on the actual transaction in order to find the arm’s length result. Instead, it would be necessary to recharacterize the actual transaction by replacing it with “an alternative transaction that affords the parties the opportunity to enhance or protect their commercial or financial position. The replacement structure should be guided by the fundamental economic attributes of arrangements between unrelated parties and comport as closely as possible with the commercial reality of independent parties in similar circumstances.”

1.1.3 Stage 3: Applying an appropriate transfer pricing method to value the ‘price’ or ‘profit margin’

The third stage involves applying an appropriate valuation method by which to determine a ‘price’ or ‘profit margin’ (or a price or margin within an acceptable range of figures) resulting from the sale of goods and/or services in the arm’s length comparable.

The menu of valuation methods consists of the traditional transactional methods, such as the Comparable Uncontrolled Price method (CUP), Resale Price Method (RPM), and Cost Plus Method (CPM). There are also the transactional profit methods, which include the Transactional Net Margin Method (TNMM) and the Transactional Profit Split Method (PSM). While the TPG and U.S. Regulations recognize that unspecified “other methods” may be used, they emphasize the need to “ensure that such methods are consistent with the arm’s length principle.”

---

18 OECD (Dec 2014), supra n.7, at page 25, para 84
19 OECD (Dec 2014), supra n.7, at pg. 26, paras 87-88
20 OECD (Dec 2014), supra n.7, at pg. 27, para 93
21 OECD (July 2010), supra n.4, at pgs. 123-125
22 OECD (July 2010), supra n.4, at part II
23 OECD (July 2010), supra n.4, at pgs. 24, 63-64; IRS Treasury Regulations, §1.482-3(b)
24 OECD (July 2010), supra n.4, at pgs. 28, 65-70; IRS Treasury Regulations, §1.482-3(c)
25 OECD (July 2010), supra n.4, at pgs. 26, 70-75; IRS Treasury Regulations, §1.482-3(d)
26 OECD (July 2010), supra n.4, at part III
27 OECD (July 2010), supra n.4, at pgs. 30, 77-92
28 OECD (July 2010), supra n.4, at pgs. 28, 93-105; IRS Treasury Regulations, §1.482-6
29 OECD (July 2010), supra n.4, at paras 2.9, 3.1; IRS Treasury Regulations, §1.482-3(e); §1.482-4(d);
1.1.4 Stage 4: Testing the transfer price

Recall that the income allocation result in a similar arm’s length transaction – i.e. a transaction that possesses the fundamental attributes/factors/characteristics/conditions of the ‘commercial or financial relations’ in the controlled transaction under review - is presumed to be reasonable according to the ALS. Having identified this comparable and derived from it the arm’s length result, it becomes possible to finally test the result in the controlled transaction under review.

If the unrelated parties’ income allocation reveals a specific ‘price’ or ‘profit margin’ (or a price or margin within an acceptable range\(^{30}\) of figures) that is consistent with that chosen by the related parties (in the controlled transaction under review), then the allocation in the controlled transaction ought to be respected by the tax authorities. But if it does not, then the allocation (in the controlled transaction) could be adjusted by the tax authorities (in order to reflect the arm’s length result) for the purpose of determining the tax consequences of the controlled transaction.

To prevent double taxation, the other State affected by the transaction would then be expected to make a “corresponding adjustment”\(^{31}\) to its taxation of the profits from this controlled transaction.\(^ {32} \) Note, however, that such a corresponding adjustment is not automatic. The other State could disagree with the transfer pricing adjustment, in which case the two States may need to resolve their dispute through their treaty’s dispute resolution mechanism(s).

1.2 A closer look at stage 1: the task of delineating the contractual terms of the actual controlled transaction

The Discussion Draft states that its proposed revisions are driven by the main aim of the Transfer Pricing Actions 8-10, which is to “assure that transfer pricing outcomes are in line with value creation.”\(^ {33} \) Of the different ways by which the Discussion Draft seeks to advance this aim, this comment is focused on its call for an “accurate delineation”\(^ {34} \) of “the substance of the commercial or financial relations between the parties, including how the parties actually operate in those relations...”\(^ {35} \)

Recall that the relevant circumstances of the related parties’ commercial or financial relations are presumed to be any of the comparability factors, which include the contractual terms of the parties’ agreement. This is reiterated in the Discussion Draft, which states that “the process of identifying the commercial or financial relations between associated enterprises follows from examining contractual terms governing those relations together with the conduct of the parties.”\(^ {36} \)

---

\(^{30}\) OECD (July 2010), supra n.4, at pgs. 123-125
\(^{31}\) This is “an adjustment to the tax liability of the associated enterprise in a second tax jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first tax jurisdiction, so that the allocation of profits by the two jurisdictions is consistent.” (OECD (July 2010), supra n. 4, at pg. 25)
\(^{32}\) OECD (July 2010), supra n.4, at pg. 139
\(^{33}\) OECD (Dec 2014), supra n.7, at pg. 38, para 1.
\(^{34}\) OECD (Dec 2014), supra n.7, at pg. 38, para 2
\(^{35}\) OECD (Dec 2014), supra n.7, at pg. 24, para 79
\(^{36}\) OECD (Dec 2014), supra n.7, at pg. 4, para 2
How are we to approach an analysis of the contractual terms? The process of delineating the contractual terms, and ascertaining their true nature (substance), essentially involves the following three steps. The first step necessitates identifying the contractual terms of the agreement, as they were formalised by the parties; i.e. the ‘legal form’ used by the parties. Having identified the terms, the second step requires determining what the contractual terms actually mean. Surprisingly, the guidelines do not specifically refer to, acknowledge, or address this task of contractual interpretation. Finally, in the third step, it is necessary to verify whether “the manner in which the transaction has been formalised by the taxpayer” (i.e. the legal form used) is consistent with the transaction’s “economic substance, determined by reference to the conduct of the parties…” (or, as phrased in the Discussion Draft, the “factual substance of the transaction as reflected in the actual conduct of the parties,”). Verification is necessary because it may be that “the parties’ actual conduct indicates that the contractual terms have not been followed, do not reflect a complete picture of the transactions, have been incorrectly characterised or labelled by the taxpayer, or are a sham.” In other words, question is whether, in reality, the parties actually did (i.e. undertook) what they formally conveyed (through the terms of their contract) as their intention to do.

If so, then the contractual terms, as formalised by the parties, ought to be recognized as structured by them, and they will represent the delineated actual transaction. If they did not, then effect ought to be given to what the parties actually did, rather than what they formally conveyed as their intention to do. This would require re-characterising the terms based on their conduct. The recharacterized terms will represent the delineated “actual transaction.” Following this verification process, the delineated actual transaction will form the basis for searching for an arm’s length comparable in the second stage of the comparability analysis.

2 The roles of ‘contract law’ and ‘private international law’ in this analysis

As stated in the preface to the TPG, it is necessary “to consider all aspects of the system that are relevant in a transfer pricing case.” Yet, whether advertently or not, the existing guidelines as well as the BEPS Action Plans are silent about a critically important aspect of the system, even though it is relevant to any transfer pricing case as well as to the BEPS Project’s objective of assuring that “transfer pricing outcomes are in line with value creation.” I am referring to the roles that contractual interpretation law and private international law necessarily have in the task of delineating the true nature of the actual controlled transaction.

38 OECD (Dec 2014), supra n.7, at pg. 4, para 3
39 OECD (July 2010), supra n.4, at para 9.34
40 OECD (Dec 2014), supra n.7, at pg. 5, para 5; pg. 17, para 43
41 OECD (Dec 2014), supra n.7, at pg. 5, para 5
42 OECD (July 2010), supra n.4, at para 1.64
43 OECD (July 2010), supra n.4, at paras 1.65, 9.183. OECD (Dec 2014), supra n.7, at pg. 24, para 80
44 OECD (July 2010), supra n.4, at para 18. As an example, the preface points out the relevance of the issue of how domestic jurisdictions allocate the burden of proof between the taxpayer and the tax authorities.
45 OECD (Dec 2014), supra n.7, at pg. 38, para 1.
As noted above, the guidelines point out the need to identify the terms of the agreement, and they elaborate on some of the different types and sources of contractual terms that may exist. They also emphasize the need to verify that the ‘legal form’ of the terms is consistent with the agreement’s substance. Yet, the guidelines fail to inform us of how to determine what the terms actually mean. This silence is particularly concerning because courts are not free to determine the meaning of contractual terms haphazardly or based on any random source of principles or rules. Rather, as the Supreme Court of Canada has cautioned, “[i]t is the duty of the courts to give effect to contracts and testamentary dispositions according to the settled rules and principles of law, since we are under a reign of law…”46 Needless to say, these cautionary words are relevant well beyond Canada’s borders.

What are the governing rules and/or principles in any given case? When a cross-border transaction is under review, determining which source of contract law actually governs (the interpretation of the contractual terms) is a question of private international law. The transaction could potentially be governed by the United Nations Convention on Contracts for the International Sale of Goods (“CISG”).47 If the convention does not apply, it then becomes necessary to determine which domestic jurisdiction’s law governs. Also, the analysis may (or may not) have to be carried out in a manner consistent with the TPG, depending on the treatment given to the guidelines under domestic law.

3 Implications of having to construe the contractual terms

3.1 The search for a reliable arm’s length comparable necessarily depends on having a properly construed controlled transaction

Again, the BEPS Project aims to provide guidance on how to assure that the transfer pricing analysis will produce outcomes which are in line with value creation. For this purpose, the Discussion Draft emphasizes the importance of properly delineating the true nature of the actual controlled transaction and, based on it, searching for a comparable arm’s length transaction that will reliably reveal the arm’s length result. The existing guidelines explain that it is important to recognize the controlled transaction as it was actually structured by the parties, and to only recharacterize it under specified exceptional circumstances, because:48

Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.

Yet, it must be acknowledged and emphasized that failure to properly identify and interpret the contractual terms also risks recharacterizing the actual transaction, though here recharacterization results from a potentially misconceived understanding of the terms. Where the scope and true nature of the terms have been misconceived, and the search for an arm’s length

46 Millar Estate, Re [1938] S.C.R. 1, pg 4
48 OECD (July 2010), supra n.4, at para 1.64
transaction is based on this misconceived understanding (of the contractual terms), the risk is that the arm’s length transaction would not be truly comparable and thus could not reveal a reliable arm’s length result.

Hence, the first implication to note is that unless the contractual terms are properly identified and interpreted, the transfer pricing analysis will not produce outcomes which are in line with value creation. This issue, therefore, is both relevant and integral to the BEPS Project.

3.2 Failure to properly identify and interpret the terms risks making an error under domestic law

But what is the proper approach to identifying and interpreting the terms? Again, the guidelines are silent about this question, either advertently or inadvertently. Consequently, the guidelines fail to provide sufficient guidance on this task of delineating the contractual terms.

Alas, even if the guidelines had also elaborated on how to interpret the terms, their attempt to do so would be of no use as long as the guidelines are not actually binding on domestic courts and do not supercede other alternative sources of contractual interpretation law. Recall the SCC’s caution that contracts must be given effect in accordance with settled rules and principles of law. Accordingly, domestic courts are not free to identify and interpret contractual terms willy-nilly or based on any random source. To properly identify and interpret the contractual terms, a court must apply the source of law that actually governs the contract in question.49 Failure to do so risks making an error under domestic law.50

This risk is exemplified by the courts’ analysis in Canada v. GlaxoSmithKline Inc. (“Glaxo case”).51 In this case, the parties in the dispute – the taxpayer, Glaxo Canada, and the Minister of National Revenue (“the Minister”) - advanced different views about the nature of the controlled transaction that was being tested under Canada’s transfer pricing law. According to the Minister, the transaction, a Supply Agreement, was essentially a cross-border acquisition of raw material (i.e. goods) from an affiliated foreign company (Adechsa). The raw material, ranitidine, was used by Glaxo Canada to manufacture the Zantac drug, which it then distributed in Canada. Glaxo Canada, on the other hand, suggested that in this Supply Agreement it actually intended to bundle payments for the raw material, received from Adechsa, as well as for (at least some of the) services received from its parent company, Glaxo Group, under a separate Licence Agreement. What was the true nature of this Supply Agreement?

A common thread in the law of contracts around the world - be it in civil law jurisdictions,52 common law jurisdictions,53 or under the CISG54 - is that the true nature of a contact is based on

---

49 See, for example: Re Nortel Networks Corporation et al., 2014 ONSC 6973 (CanLII), paras 282-283.
50 See, for example: General Motors of Canada Ltd. v. R., 2008 FCA 142, paras 31, 42
51 The case was first decided by the Tax Court of Canada (“TCC”): GlaxoSmithKline Inc. v. R., 2008 TCC 324 (“Glaxo-TCC”). The case was then appealed by the taxpayer to the Federal Court of Appeal (“FCA”): GlaxoSmithKline Inc. v. R., 2010 FCA 201 (“Glaxo-FCA”). The Minister then made a final appeal to the Supreme Court of Canada (“SCC”): Canada v. GlaxoSmithKline Inc., 2012 SCC 52 (“Glaxo-SCC”).
the parties’ agreed to intentions. It is therefore necessary to ascertain the parties’ contractual intentions in order to delineate the true nature of a contract. In the Glaxo case, for example, did the parties intend to have Glaxo Canada pay consideration for the goods and nothing more, or did they instead intend to have it bundle payments for both goods and services received under the two separate agreements?

Looking exclusively within the four corners of the Supply Agreement, the trial judge, Associate Chief Justice Gerald J. Rip (“Rip”), found that the only thing of actual value received by Glaxo Canada was the raw material,\textsuperscript{55} which (apparently) led him to infer that Glaxo Canada intended to pay for the goods and nothing more.\textsuperscript{56} Based on this understanding of the actual transaction, Rip accepted the Minister’s view that “the issue in these appeals is not what is a reasonable price for Glaxo Canada to pay to sell Zantac in Canada; it is what is a reasonable price for Glaxo Canada to have paid for a kilogram of ranitidine.”\textsuperscript{57} Accordingly, Rip decided that the agreement was properly comparable to the purchases of generic ranitidine by Apotex and Novopharm from arm’s length manufacturers, since these transactions involved equivalent raw materials and nothing more.\textsuperscript{58}

In contrast, the SCC looked to extrinsic evidence of Glaxo Canada’s business reality; particularly, its commercial purpose to obtain the right to sell the Zantac brand, and the requirement under the Licence Agreement to acquire the raw material from Adechsa.\textsuperscript{59} Based on that extrinsic evidence, the court inferred that Glaxo Canada intended to bundle payments for the raw material, received from Adechsa under the terms of the Supply Agreement, and for “at least some of the rights and benefits under the Licence Agreement as part of the purchase price for ranitidine from Adechsa.”\textsuperscript{60} Considering this intention, the court held that the Licence Agreement could not be ignored in determining the reasonable amount paid to Adechsa.\textsuperscript{61} It also held that the arm’s length purchases of the generic ranitidine were not comparable because they “do not reflect the economic and business reality of Glaxo Canada.”\textsuperscript{62}


\textsuperscript{54} UN (2010), Article 8

\textsuperscript{55} Glaxo-TCC, para 16

\textsuperscript{56} Glaxo-TCC, para 139

\textsuperscript{57} Glaxo-TCC, para 139

\textsuperscript{58} Glaxo-TCC, para 118

\textsuperscript{59} The court explained that Glaxo Canada wanted to be in the business of “secondary manufacturing and marketing of brand-name pharmaceuticals, including Zantac.” (Glaxo-SCC, para 45) This required it to obtain a licence from the trademark holders of brand-name drugs. (Glaxo-SCC, para 52) With regards to the Zantac drug specifically, it had to obtain a Licence Agreement from Glaxo Group, the trademark holder. (Glaxo-SCC, para 47) “The rights and benefits of the Licence Agreement were contingent on Glaxo Canada entering into a Supply Agreement with suppliers to be designated by Glaxo Group.” (Glaxo-SCC, para 49) This condition would have existed regardless of whether Glaxo Canada was controlled by Glaxo Group. (Glaxo-SCC, para 47).

\textsuperscript{60} Glaxo-SCC, para 51.

\textsuperscript{61} Glaxo-SCC, para 51-52. The court refrained, however, from making any concrete conclusions about whether the Licence Agreement was actually linked to the transfer price (Glaxo-SCC, para 57).

\textsuperscript{62} Glaxo-SCC, para 53
The question is, were these Canadian courts legally correct in how they approached ascertaining what the contractual terms of the Supply Agreement meant? Were they correct in how they delineated the true nature of the parties’ agreement (i.e. what the parties intended to carry out by their agreement) based on the parties’ formalised contractual terms? In this case, as in any other transfer pricing case, there is only one legally correct way of reaching this determination: by applying the law of contractual interpretation that actually governs the contract in question. Yet, the courts in this case gave no indication that they construed the contractual terms in accordance with the applicable law of contractual interpretation. There is a risk, therefore, that the courts failed to properly construe the terms, which could have resulted in an error under domestic law. It would appear likely that this same risk exists in other transfer pricing cases around the world.

3.3 The potential application of different sources of contract law could create the incentives and opportunities for legal arbitrage, which in turn could facilitate transfer pricing schemes

The OECD explains that “BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place.” A tax policy concern of the BEPS Project, therefore, “is that, due to gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed.” As part of its action plan, the BEPS Project sets out to establish new standards that will establish international coherence of corporate income taxation.

Yet, confronting the risk of tax arbitrage is not enough. The international tax regime is a pluralistic legal system in which the potential for legal arbitrage extends beyond this risk of tax arbitrage. This potential arises, for example, from the existence of alternative sources of contract law.

While the different sources of contract law may share some common objectives and approaches, there are also gaps and differences among them. For example, while different sources of contract law typically share the cardinal objective of ascertaining and giving effect to the parties’ contractual intentions, their approach to ascertaining these intentions may vary. Common law jurisdictions focus on giving effect only to those subjective intentions which, when seen objectively, were conveyed by the parties through their contractual terms. Civil law jurisdictions, on the other hand, look for the parties’ subjective intentions, irrespective of whether their intentions were conveyed by the terms or instead had to be revealed through extrinsic evidence. As for the CISG, it applies a hybrid of these subjective and objective approaches.

Note that the parties’ intentions, as formalised by their terms, would still need to be verified against the substance of the agreement, as evidenced by their actual conduct. That is, did the parties actually do that which, according to the legal form of their agreement, they intended to do?

DOI: http://dx.doi.org/10.1787/9789264202719-en

Ibid, pg. 10.

Gaps and differences among different sources of contract law could lead to material differences in the outcome of the transfer pricing analysis. These differences could either advantage or disadvantage the taxpayer and tax authorities in the dispute.

Assume, for example, that the Supply Agreement was governed by Canada’s common law of contractual interpretation. Within the common law’s legal framework, Glaxo Canada could have been expected to face numerous hurdles in establishing its intention to bundle payments. The courts would have been expected to only give effect to those intentions that, when seen objectively, were conveyed by the terms, either expressly in a written document or by implication from their conduct. Yet, as it appears, the expressed terms of the Supply Agreement make no mention of an intention to bundle payments and the plausibility of implying such a term seems doubtful. Moreover, while extrinsic evidence from the Supply Agreement’s surrounding circumstances could be admissible for the purpose of explaining the meaning of the terms of the contract, they could not be used as a source from which to infer the parties’ subjective intentions, unless doing so was necessary to resolve latent ambiguity. It would appear that the SCC in this case may have erred by making such an inference.

Alternatively, assume that the Supply Agreement was governed by the CISG. Within this legal framework, Glaxo Canada could be expected to more easily establish its asserted subjective intention to bundle payments. Pursuant to Article 8 of the CISG, the courts would not be confined to finding Glaxo Canada’s intentions within the contractual terms. Rather, they would be required to admit any extrinsic evidence that would reveal Glaxo Canada’s subjective intentions, so long as the other party knew or could not have been unaware of that intent. 67

Hence, as this example shows, the source of contract law could make a material difference in the court’s construction of the true nature of a controlled transaction. Under the CISG, Glaxo Canada could more easily establish its intention to bundle payments, which could support its argument that the arm’s length purchases of the generic ranitidine were not comparable since they only involved the sale of raw material and nothing more. By controlling which source of contract law will govern the interpretation of their agreement – by using, for example, ‘choice of law’ clauses - taxpayers can thus use legal arbitrage to facilitate their transfer pricing schemes. This risk is relevant to the BEPS Project’s objectives, and should therefore be addressed.

4 Conclusion and proposal for reform

For at least the following reasons, the BEPS Project should not overlook the role and implications of contract interpretation law and private international law in the transfer pricing analysis.

Firstly, the task of contractual interpretation is a necessary part of the process of delineating the actual controlled transaction. It is a fundamental precept of contract law around the world that effect should be given to the parties’ contractual intentions, as ascertained by a legally correct

---

67 Note, however, that where an inquiry into the parties’ subjective intention is not applicable - for example, because the subjective intent was not known to either party - Article 8(2) requires conducting an objective assessment of the parties’ intentions.
construction of the contractual terms; unless there is a legally valid reason for recharacterizing the transaction. Without a legally correct construction of the contractual terms, there is real risk that the search for an arm’s length comparable will be based on a misconceived understanding of actual transaction. The use of an arm’s length transaction that does not reflect the parties’ intentions in the controlled transaction (since it is based on a misconceived understanding of the terms, rather than being based on a legally correct interpretation) could not be comparable, and consequently would not lead to a reliable arm’s length result.

Secondly, failure to properly construe the contractual terms would risk having the courts make an error in their analysis under domestic law.

Thirdly, it is necessary to address the potential risk of legal arbitrage which is currently made possible by the existence of alternative sources of contract law. Such legal arbitrage could potentially facilitate transfer pricing schemes.

This author recommends that the BEPS Project should consider coordinating principles of contractual interpretation that would apply to the supply of goods and services in cross-border transactions, at least for the purpose of the transfer pricing analysis. Having such coordinated principles would eliminate the incentive and opportunity for legal arbitrage in this context. Yet, such coordinated principles ought to be backed by a ‘hard law’ commitment, so that the principles will be binding on domestic courts and will supercede other sources of contract law. This is necessary because otherwise domestic courts would still have to determine which source of contract law actually governs the contract in any given case, irrespective of any coordinated non-binding ‘soft law’ sources.
AOTCA Opinion Statement on the OECD 2014 Public Discussion
Draft on Revisions to chapter 1 of the Transfer Pricing Guidelines

Prepared by the AOTCA Technical Committee and submitted to the OECD on 4 February 2015
AOTCA was founded in 1992 by 10 tax professionals’ bodies located in the Asian and Oceanic regions. It has expanded to embrace 20 leading organizations from 16 countries/regions.

The foundation of AOTCA was attributed to the existence of the Confédération Fiscale Européenne (CFE), the international organization for tax advisors in the European Communities with a long history of 49 years.

Over the years tax professionals doing businesses in the Asian and Oceanic regions had been strongly conscious of the necessity that the same international professional body as CFE would exist in the area.

Introduction

The following comments relate to the OECD’s Public Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (including risk, re-characterisation and special measures).

1. With respect to Paragraph 38 situations can be envisaged where a purchaser of technology may not normally, in an arm’s length situation, take all the risk without product indemnity. Clearly there would be an arm’s length situation where risk was assumed for an appropriate premium reflected in the price. Similarly in paragraph 60 there is an assumption that a manufacturer cannot deflect risk in appropriate circumstances. This is not correct.

2. Option 3. The thick capitalisation approach is too restrictive and ignores the commercial activity in recognised low tax financial markets such as Singapore and Hong Kong.

3. Option 5. The x% selected as a benchmark must be less than the current tax rates in Singapore and Hong Kong.
Buenos Aires, February 6, 2015

Mr. Andrew Hickman
Head of Transfer Pricing Unit
OECD’s Centre for Tax Policy and Administration

E-mail Response: TransferPricing@oecd.org

RE:  BEPS ACTIONS 8, 9 and 10. Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, re-characterisation, and special measures)

Dear Mr. Hickman,

The Transfer Pricing working group of the Asociación Argentina de Estudios Fiscales (Argentine Association of Tax Studies – AAEF) is pleased to provide comments on the OECD’s paper on Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, re-characterisation, and special measures) related to Actions 8, 9 and 10 of the BEPS Action plan.

AAEF is a non-profit organization based in Argentina, whose active members are recognized tax experts from both, private and public sector. AAEF is the local branch of the International Fiscal Association1.

We welcome the initiative to focus in topics as controversial as risks and re-characterisation of the transactions, while we consider that further work needs to be done to align the wording of these guides with real situations and actual business cases. Moreover, we have some concerns on how the special measures proposed, which clearly step further from the arm’s length principle, might reduce controversies among countries, help in levelling the playing field and boost investment and global trade in the long run.

We comment and assess the proposed amendments to Chapter I, hoping they can contribute to the better development of the subject.

General Comments on Special Measures Proposed

Even though it might be necessary to refine the wording of Part I of the Draft, in general terms we agree with the assessment made in Part II, Paragraph 2, where it says that the

1 Created in 1953, the Argentine Association of Tax Studies committed itself in its 61 years to promote research on Fiscal Law and related disciplines among its members.
revisions to Section D of Chapter I of the Guidelines set out in the Part I of the Draft will go far in aligning where profits are reported and where value is created.

However, the next paragraph (Part II, Para. 3) argues that such changes might not be enough due to “… information asymmetries between taxpayers and tax administrations and the relative ease with which MNEs groups can allocate capital to lowly taxed minimal functional entities (MFES)”.

In this regard, it is worth further examining the assumptions on which the assessment relies:

1. Even though information asymmetries could exist, there is a myriad of BEPS efforts towards improving transparency (Actions 5, 11, 12 and 13 among others), that will level by themselves the playing field.
2. Moreover, it should not be assumed that information asymmetries will always benefit the taxpayers. Due to the increasing network of treaties to exchange information between the tax authorities, they could be better positioned to a greater access to potential comparable transactions and information on business practices from different taxpayers worldwide.
3. Finally, if special measures were to be put in place, they should be limited to those extraordinary cases of non-collaborative taxpayers. If access to information is the problem, there are better tools to tackle it (e.g. improving and easing APA programs) than establishing special potentially non-arm’s length measures.
4. In addition to that, it is worth wondering whether they should be coped within the transfer pricing and arm’s length matters or they are odd to this general framework and could be derived more naturally from other rules (e.g. CFC rules).

Last but not least it is worth recalling that taxes are part of the cost structure of the companies. Where appropriate substance exists (and functions, assets and risk are actually migrated and performed in the location), a value chain realignment or business restructuring should not be impeded solely on the grounds that it lacks business purpose other than a tax-driven objective. Since taxes are part of the business cost, such an approach will imply discriminating against set-up business in favor of newcomers, thus jeopardizing competitiveness and global efficiency.

It could be argued that the different taxing systems (in particular low tax jurisdictions) distort the global allocation of resources and, thus, it is fair to fight against it. Nonetheless
it is important to consider whether or not the arm’s length principle and transfer pricing rules are good instruments to boost the harmonization of the different tax systems.

Moreover, it could be counter-argued that in the long run the continued actual migration of capital, functions, assets and risk will turn the low tax jurisdiction resources (i.e. material and human resources) scarce and thus costly, balancing the benefits of a low tax regime. However, the relevant issue is to grant the appropriate substance, and nothing else than that.

In addition to that, disregarding the tax driven allocation of resources as a genuine economic reason may result in a less than optimal situation for the global economy in the long run, considering that less competition between the different states for the tax revenues could reduce the due care to optimize public expenditure efficiency.

Part II, Paragraph 6 sets out that it is not critical to determine whether a special measure is in one side or the other of the boundary of the arm’s length principle. We wonder how a measure that goes beyond the arm’s length principle could create a transfer pricing outcome in line with value creation, as the document sets as the aim of such measures. We see a contradiction between the stated purpose of the special measures and their tax effects because, in order to achieve a transfer pricing outcome in line with value creation, it has to be an arm’s length one; thus we conclude that the aim of special measures is to avoid BESP risks, beyond the transfer pricing outcome and whether it is appropriate or not to deal with them under these Action Plans.

Any special measure that takes into account certain pre-determined quantitative threshold to be applied will lead to an outcome beyond the arm’s length principle, and as a consequence it could impact on genuine business decisions.

Special Measures in Particular

Below we comment on why we understand that the inclusion of each one of the special measures proposed should be carefully revised.

Option 1: Hard to Value Intangibles

- It is not true that the only way to deal with highly uncertain valuation environment is to agree on future contingent payments. Moreover, such an approach has a significant hindsight risk since the contingent payment adjustment to be made by the tax authorities
will necessarily be calculated with ex-post information. Please bear in mind that the transfer of intangibles usually implies pricing uncertain events or, in other words, pricing the risk.

- There are well known valuation techniques to deal with highly uncertain valuation environments (e.g. real options methodology). We suggest providing more guidance on the different valuation approaches in the Chapter VI of the Guidelines.

- Further guidance must be developed – and eventually mechanisms to inform the relevant tax authorities regarding how the taxpayers should contemporaneously document the business estimates used in their valuation analyses.

- Instead of stating a general presumption measure to be applied by tax administrations, which implies reverting the burden of proof to the taxpayers, the measure may be established in the opposite way, as a last resource, for cases where taxpayers fail to demonstrate the robustness of their projections. Another alternative measure may be a compulsory submission to an APA process, which would allow tax authorities to verify the assumptions on which the transfer price was agreed.

Option 2: Inappropriate returns for providing capital – Independent investor

- There could be a significant number of reasons, other than tax reasons, that could lead an independent investor to invest in the capital-rich, asset owning company instead of making the investment either in the company with the managing capabilities or in the asset itself. Among other reasons we can mention: limiting the business liability, better intellectual property protection rules, lower country risk, better regulations that may allow the investor to take advantages of synergies to expand the business to new markets, etc.

- As far as the investor keep the management decision on the assets and prove that there are business reasons to keep it separate, there should not be reasons to disregard the structure.

- Regarding the alternative measures to reallocate the inappropriate returns for providing capital set out in the document, they lead to different results. Under the first one (the reallocation of the capital contribution to the company that generates the return
of the asset), the immediate effect will be the non-recognition of the return to the capital-rich, asset-owning company, as well as the non-deduction of any expense relating the use of the asset for the company that generates the return (except from the depreciation of such asset). Thus, the measure avoids the possibility of profit shifting in favor of the asset owning company.

- Under the second situation, the effect is the reallocation of the asset’s return to the parent company, but it does not mean a relief against BEPS risks from the perspective of the company that conducts the managing activities regarding the assets. Thus, it is clear that both alternatives have similar effect in respect to the capital-rich asset-owning company, avoiding the recognition of the return, but only the first one implies that such return will remain in the company with economic substance to manage the asset.

Option 3: Inappropriate returns for providing capital – Thick capitalization

- First topic to be discussed is whether or not providing capital has to be compensated as debt. The document does not make explicit the BEPS mechanism that it intends to tackle. Nonetheless, as a consequence of the measure, fix ratios for tax purposes will apply in order to allocate equity or debt investments, beyond the decision of the investors.

- Moreover, financing structures differ from business to business and within the same business at different points of the life cycle, thus determining a general ratio might be inappropriate. Taxpayers should be allowed to demonstrate that the financing structure of their business is aligned with arm’s length practices.

- For instance, determining a fixed ratio for the entire group might yield inconsistent results in a mining MNE, where the group is at a production stage while a subsidiary only carries out exploration activities. Applying the group’s ratio to the latter might allocate a deductible expense that might not take place on a standalone basis under arm’s length conditions.

Option 4: Minimal functionality entity
• Determining qualitative and/or quantitative attributes applicable to any kind of companies and industries could be a challenge greater than analyzing the facts and circumstances under the guidance proposed in Part I of the Draft.

• A common pattern to the proposed threshold is conducting business with group companies. Nevertheless, this is not per se an indicator of lack of substance.

• We wonder which would be the rule to choose from the three different options proposed to reallocate the entity’s profit, taking into account that the reallocation of the business profit of the minimal functional entity might not be an option for the tax authorities of the country where the company providing the relevant functional capacity resides, because of lack of information. This will usually be the case unless the latter were the parent of the former, or where an exchange of information Treaty is in force. Also, applying profit split method could be a good measure for APA purposes but it may not prove effective where tax administrations intend to make a transfer pricing assessment if they do not have the legal possibility to access to the minimal functional entity’s business details.

Option 5: Ensuring appropriate taxation of excess returns

• The CFC rule is effective from the country of the parent company perspective, beyond any transfer pricing regulations. The primary CFC’s rule measure seems to be reasonable and implies the widespread adoption of the CFC rule but limited to excess returns. This limitation is likely aimed at protecting differing tax alternatives but poses the challenge of defining the dividing line of “regular returns”. Again it has to be said that any time a quantitative threshold is set, inappropriate outcomes might result because it means a rough measure, what is inconsistent with the arm’s length principle.

• The secondary rule seems to be more an ideal one that a practical solution. We do not believe that a pre-determined rule to allocate the excess returns could be agreed by all the countries involved but, more important is to say that such kind of reallocation measures, based on spreading part of the income between the jurisdictions that could have contributed to obtain it, is more linked to a global formulary apportionment than to the arm’s length principle.
The existence of excess returns for one of the MNE entities may be considered as an indicator of a transfer pricing risk instead of an automatic trigger for a transfer pricing assessment.

**Proposed additions to Section D of Chapter I of the Transfer Pricing Guidelines**

Below we provide our feedback to some of the proposals included in the Draft.

- Even though it could be correct to re-characterise the transaction under the assumptions developed in the example of paragraph 6, we understand that it would be necessary to expand the example or at least advert of the other taxes and/or Permanent Establishment implications involved in this solution.

- The mere transfer of seconded employees does not imply the provision of know-how. We suggest making clarifying in Paragraph 7 that the mere secondment does not imply the existence of an implicit transfer of know-how if there is not clear intention of the parties to do so. It is worth noting that any time an employee leaves a company he or she takes with himself or herself the knowledge obtained during the employment relationship, and that the human capital created cannot be capitalized by the company in such arm’s length cases.

- Example in Paragraph 47 might bring more confusion than clarity. Even though where there could be cases where the facts are aligned with the example, it should not be taken for granted that the “in-any-case trader” is a simple routine entity that does not manage associated risk and, thus, it is not entitled to the corresponding return. Even though it is true than no party could materially affect the market prices for commodities, there is room for decision making and risk taking activities, e.g. going short or long in the position, having a hedged or speculative strategy, developing commercial relationships with the refiners, etc. When these functions are carried out by the trader, it must not be entitled only to a routine return.

- Paragraph 67 states “[c]ommon risks transfers would typically come under... transactional risk and hazard risk.” And that “[s]ome financial risk...may also be transferred”. However, even though less common, there are situations were strategic risk
or market place risk or infrastructure or operational risks are also transferred (e.g. a performance guarantee).

Should you have any inquiries or doubts, please do not hesitate to contact us at the e-mail addresses below.

Sincerely,

Horacio R. Della Rocca: President

Cecilia Goldemberg. Transfer Pricing Working Group Co-coordinator. Cecilia.goldemberg@gshr.com.ar

José María Segura. Transfer Pricing Working Group Co-coordinator. segurajosemaria@yahoo.com.ar
OECD Discussion Draft under BEPS Actions 8 – 10 on Risk, Recharacterisation, and Special Measures (the “Discussion Draft”)

We welcome the opportunity to comment on the OECD’s discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures), as issued on 19 December 2014. We are pleased to contribute our comments below.

General comments on Part I

We strongly agree with the approach taken by the OECD to provide a comprehensive guide to transfer pricing which recognises the need to identify commercial or financial relations in order to accurately delineate transactions and apply the arm’s length principle. The emphasis placed on the actual conduct of parties is appropriate in order to confirm alignment and consistency with contractual terms between the parties for the purpose of delineating a transaction. Where the contractual terms are not aligned with actual commercial or financial relations, we support the view that the conduct should ultimately be used to determine the delineation of a transaction.

We also agree that the process of accurately delineating a transaction requires an understanding of the economically relevant characteristics of that transaction in order to ensure robust comparisons with uncontrolled transactions. We generally agree with the list of options found in paragraph 10 but note with regard to the fifth bullet point (‘business strategies’), it is often difficult to identify individual entity business strategies within an integrated group, as all parties are generally aligned to a single global strategy. Tactics employed and decisions made at a local level may be of less significance in the context of a central group strategy, therefore it is important that a broader understanding is attained in determining appropriate comparability factors.

When considering the concept of options realistically available, it is crucial that the word ‘realistically’ is considered in the context of the existing resources available to the entities and not extrapolated to introduce options that are more aspirational than realistic. The incorrect application of the concept is likely to result in arriving at less robust comparables.

We strongly support the view that risk and risk management are very important factors in determining the commercial or financial relations in order to identify comparables. It is important to understand the significant economic activities and risks assumed that drive economic value.

In our view, the categories of risk identified in paragraph 42 are accurate and we would wish to emphasise the importance of understanding the significance of the risks identified.
The alignment of risk with the capability to manage that risk is an important fundamental principle of securing an accurate analysis of commercial and financial relations between controlled parties and in determining comparables. To ensure the transaction is accurately delineated, we agree that it is necessary to review the contractual risk allocation and to analyse the conduct of parties.

The continued recognition that different entities within a global group can have different risk profiles is welcomed. The functions and risks assumed by each entity over the long term should be recognized within the analysis, and their respective remuneration should reflect those functions and risks appropriately. It is important that the analysis recognises investment, and the inherent risks of such investment, which may have taken place several years before any value is subsequently realised.

We agree that the moral hazard concept is useful in that it helps to identify the artificial separation of risk and substantial risk management capability, something that rarely happens in transactions between independent parties. However, it may be the case that during negotiations between independent parties, one party may be allocated risks against that party’s wishes or interests. The party may accept the risks allocated to ensure the deal progresses, but would promptly be required to put in place the relevant capability to manage the new risk.

It should be accepted that in transactions between associated enterprises the existence of common control will generally mean that there is no need to contractually align incentives in order to ensure that one party will not act contrary to the interests of the other. Whereas the unrelated party context it would be expected for contracts to provide for extensive protections via contractual language. This particular difference in contractual construction should not be taken into account in assessing comparable transactions.

Similarly, we feel that the ‘risk-return trade-off’ (as described on page 14 of the Discussion Draft) is a recognised commercial concept that is applicable in controlled party transactions. For example, this trade-off should specifically be respected in the instance where property being transferred has been the subject of a robust and documented valuation study and provided that the various financial projections, discount rates, etc. can be supported as comparable to dealings with unrelated parties (from both a company view and a market view).

A pragmatic approach is needed with respect to the allocation of risk between parties. It may be difficult to calculate the return required for risk management and we agree with the OECD’s comments that in many situations no separate compensation for risk management should be required since a return is generally implicit in the transfer price. The key is to focus on significant risks and to ensure alignment to entities capable of managing those risks. We should avoid situations where less significant risks are reallocated between parties despite both being capable of managing them. Such practices are likely to lead to an increase in tax disputes, double taxation and uncertainty. In our view, the OECD should require taxpayers to identify the significant risks and demonstrate alignment with substantive, capable management.

We welcome the recognition that associated entities may have the ability to enter into a much greater variety of arrangements and therefore the fact a transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm’s length arrangement. It is important that the underlying business reasons for a
transaction are considered to ensure a fair and consistent outcome under the arm’s length principle. It would be undesirable to recharacterise such transactions simply because they occur infrequently, if at all, between independent parties.

We agree that the non-recognition, or recharacterisation, of transactions for transfer pricing purposes should only be applied in exceptional circumstances. The arm’s length principle is the cornerstone of transfer pricing and therefore any deviation from this established principle should be carefully considered. One of our primary concerns with non-recognition is that the guidelines may be misinterpreted, leading to instances where tax administrations use such provisions to recharacterise transactions in inappropriate circumstances. For example, paragraphs 90 to 91 ignore the fact that S1 receives a lump sum payment of $400m, generally a taxable receipt, which it may choose to use for other investment opportunities. It should not follow that a transaction lacks fundamental economic attributes simply due to the fact that one party receives a lump sum payment as part of that transaction.

We agree that an associated enterprise should not be considered to receive an intra-group service or required to make any payment when it obtains incidental benefits attributable solely to its being part of a larger MNE group. We further agree that the term incidental does not refer to the quantum of such benefits or suggest that such benefits must be small or relatively insignificant when such benefits (or burdens) arise purely as a result of membership in an MNE group and without the deliberate concerted action of group members.

We understand the need to revisit the criteria for recharacterisation and the use of "fundamental economic attributes of arrangements" to support analysis of commercial rationality - the first leg of the current criteria for recharacterisation. We appreciate the repeated statement that MNC’s may enter into transactions that are not in evidence between independent parties and that this is not sufficient grounds for non-recognition. As an example, our essentially captive market / distributor or manufacturing subsidiaries do not generally take on these functions on behalf of independent parties, relying solely on central support and supply of "home grown and owned" products. This should not be a case for recharacterisation.

In describing the fundamental economic attributes in paragraph 89, we recognise the reasonable expectation of enhancing or protecting commercial or financial positions on a risk adjusted basis as an appropriate characterisation of any uncontrolled transaction. Therefore, applying this standard to controlled transactions is a useful way to identify those transactions which would not be entered into between third parties. The example makes this clear and is welcomed.

**General comments on Part II**

We recommend that continuing thought be given to the proposition that the augmented sections in Part D - Guidance in Applying the Arm’s Length Principle, will have made a significant and effective contribution to countering BEPS to the extent that some of the special measures proposed would not be necessary. In our view, the vast majority of transactions should be capable of being tested by reference to a functional analysis in order to ensure adherence to the arm’s length principle.
In particular in dealing effectively with the analysis of risk and appropriate allocation, there should be very limited or no scope remaining to shift disproportionate profits to over-capitalised, low functioning entities. This means that the special measures options of inappropriate returns for providing capital, independent investor, thick capitalisation, minimal functional entity, and CFC type rules should have limited application only in exceptional circumstances where a transaction lacks the fundamental economic attributes of arrangements between unrelated parties.

Our conclusions are underpinned by the view that capital should follow risk and not the other way round. Functionality and capability (including risk management) are primary requisites for attracting capital and investing for returns. This is how the uncontrolled commercial world works and the arm’s length principle should adhere to this principle.

**General comments on Potential Special Measures Option 1**

We firmly believe that such a measure should only apply after every effort to test the transaction as contracted by reference to functionality, risk and comparability. The reworked guidance on risk should be effective in eliminating many offshore transfers to low functioning entities devoid of risk management or other relevant substantial capabilities. It is imperative that the rules target exceptional transactions only and are not so broad that they invite application to genuine commercial transactions. Any special measure should be a specific, targeted anti-avoidance rule.

In the pharmaceutical industry third party licences and similar transactions are entered into on a daily basis for IP in all stages of development. The relevant economic characteristics are understood and can be applied to the facts. We do agree that the taxpayer has a responsibility to produce the relevant business information to support the IP transfer. This should be commercially based and free from tax based prejudice. In cases of full disclosure and market benchmarks, there should be less cause to apply special measures on the grounds of asymmetry of information.

Hard to value intangibles often lead to a sharing of risk and reward between two parties as each side effectively hedges against the intangible performing badly or very well particularly before commercialisation. In such circumstances a fixed price upfront may not be justified based on comparables. However, AZ has acquired the equity of many biotech companies all of which are effectively at a fixed price upfront (contingent value rights are rare). The fixed price approach is not an uncommon form of consideration. For this reason, we do not support targeting IP transfers on the basis of the form of consideration. Other factors are more indicative for the imposition of any special measures including the absence of full disclosure.

If it is the case that the functional analysis fails to deliver a satisfactory outcome in respect of intangibles owing to lack of cooperation to supply business data then a special measure could be employed in extremis. Rebasing the calculation of the consideration based on actuals in these extreme circumstances would be made with the benefit of hindsight, however this is potentially the price paid by a taxpayer for not providing relevant contemporaneous documentation and not supporting a transfer of IP to a low functioning, low or zero taxed entity.

The rebuttable presumption is a useful back up for the taxpayer. The commensurate with income corridor approach provides some taxpayer protection assuming originating data is
available, however given the volatility of assets in biopharmaceuticals and the propensity of tax authorities only to audit very successful products, this is unlikely to be that helpful. Furthermore, we have concerns with the use of fixed percentages to determine whether or not a presumed price adjustment can be rebutted. Such a rule has the potential to give rise to numerous tax audits and disputes which could span a number of years. This will increase the administrative burden, compliance costs and uncertainty for taxpayers.

The ability of a taxpayer to demonstrate the robustness of its commercial ex ante projections is really the only way a taxpayer should be presenting its case for a transfer of IP intra-group.

We recommend that any future guidance on Option 1 narrow the application of a special measure in order to target egregious arrangements and to manage the administrative burden and compliance costs for taxpayers and tax authorities. Taxpayers should be given the opportunity to demonstrate the robustness of the valuation before the tax administration is able to presume application of a special measure. To allow tax administrations to rebase calculations based on actual outcomes in anything other than the most extreme circumstances involving low functioning entities in low or zero tax jurisdictions creates uncertainty and disputes the tax system can ill afford.

**General comments on Option 2**

A functional analysis undertaken in line with the augmented guidance in Part D should determine whether the functions of a capital-rich, asset-owning entity’s function are limited and should enable restrictions on its returns. The concept of an independent investor is ambiguous and may present wide scope for disagreements between taxpayers and tax administrations.

**General comments on Option 3**

As noted above, a functional analysis should be undertaken to determine the functions and risks to ensure the arm’s length principle is appropriately applied. A benchmarked fixed ratio may have some application here but again only in targeted, egregious circumstances where an entity is devoid of substance, risk management capability and in a low or zero taxed entity the main purpose of which is to accrue a tax advantage.

Further consideration should also be given as to how a rule which deems interest will interact with the OECD’s work in relation to Action 4.

**General comments on Option 4**

A functional analysis (and the country by country report) should expose those entities with minimal functions. We would expect the functional analysis and correct application of transfer pricing guidelines to result in a position which accurately reflects an arm’s length arrangement. The inclusion of this option seems unnecessary and increases the risk that the special measures will be applied a broader range of transactions than is desirable.

The options considered for reallocating an entity’s profits do not seem appropriate given that they are unlikely to result in an allocation of profits which reflects an arm’s length arrangement. Instead, neither a mandatory profit split nor the reallocation of profits to a
parent up the chain will solve the issue at hand and may simply lead to a further misallocation of profits.

**General comments on Option 5**

Effective CFC legislation is a tried and tested route to mopping up un-apportioned profits from low taxed, low functioning entities. They act as a back up to the appropriate application of transfer pricing guidelines. We agree that there is a role for an effective CFC rule which applies to those transactions which do not demonstrate fundamental economic attributes of arrangements between unrelated parties. However, this is only ever going to be a second order measure to the proper application of transfer pricing principles outlined in the discussion document.

The secondary rule deviates from the arm’s length principle and is likely to result in a further misallocation of profits. Such a rule will result in an increase in tax investigations as tax authorities try to determine whether they have been allocated what they see as their ‘fair’ share of excess profits. Clearly there is an overlap with Action 5 here.

We appreciate the opportunity to submit our views and look forward to making further contributions on the subject. Should you wish to discuss our response further in a meeting or on a call then please do not hesitate to contact me.

Yours sincerely

Ian Brimicombe
Vice President Corporate Finance
AstraZeneca
6 February 2015

Mr Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue André Pascal
75775 Paris Cedex 16
FRANCE
Email: TransferPricing@oecd.org

Dear Mr Hickman,

Public Discussion Draft – BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines

The Australian Bankers’ Association (ABA) welcomes the opportunity to comment on the proposals in the OECD’s Public Discussion Draft – BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guideline (including risk, recharacterisation and special measures) (Discussion Draft).

The ABA is the peak industry body for Australian banks. Its 23 members comprise all of Australia’s major banks, as well as other Australian owned and foreign owned banks operating in Australia.

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services.

The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry’s contribution to the economy and to ensure Australia’s banking customers continue to benefit from a stable, competitive and accessible banking industry.

This submission is concerned with the issue of risk, as addressed in the Discussion Draft, given how important risk is to the activities of banks and other financial services organisations. The Discussion Draft is also concerned with other issues, i.e. recharacterisation of transactions, and transfer pricing rules or special measures for transfers of hard-to-value intangibles, that are beyond the scope of this submission.

The Discussion Draft (of its own admission) does not even begin to consider the special issues that arise for banks as regards the transfer pricing treatment of risk, apart from posing some questions directed towards the financial services (as noted in the Appendix to this submission).
The ABA wishes to make the following five key points in relation to the treatment of risk in the Discussion Draft:

1. Given the complexity of the issues, there simply has not been time, within the confines of the deadline set for comments, for the ABA to respond in a substantive way to the financial services-specific questions in the Discussion Draft.

2. More importantly, the OECD has already provided considerable bank-specific tax guidance on the subject of risk (see comments in the Appendix).

3. In light of that extensive and relatively recent guidance, it is not clear to the ABA why any further OECD directive on risk, in the context of banks, is warranted.

4. If this project is to extend to the financial services sector, the ABA urges the OECD to consult extensively with the banking industry before, and during the course of, developing any special rules for banks.

5. It will be important to ensure that any changes to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as proposed by the Discussion Draft, are consistent with the existing OECD guidance.

Please do not hesitate to contact the ABA if you would like to discuss any of the above matters.

Yours sincerely,

Steven Münchenberg

cc. Hon Josh Frydenberg, MP, Assistant Treasurer
    Mr Rob Heferen, Executive Director, Revenue Group, The Treasury
    Mr Andrew Mills, Second Commissioner, Law Design and Practice Group, Australian Taxation Office
APPENDIX

Scope of the Discussion Draft – as regards risk, and financial services

As the Discussion Draft notes on page 1, Actions 8, 9, and 10 of the BEPS Action Plan relate to a number of closely related topics, including the development of:

... 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 contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation.

Part I of the Discussion Draft contains a proposed revision to Section D of Chapter I of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TP Guidelines). The proposals emphasise the importance of accurately delineating the actual transactions, and include guidance on the relevance and allocation of risk. Amongst other things, the proposed revision seeks to provide guidance on determining the economically relevant characteristics or comparability factors of the controlled transaction.

It is self-evident that Part I of the Discussion Draft does not take into account in any significant way the special issues that arise for banks, as regards the importance and role of different types of risk in their businesses. Apart from the brief discussion in paras 129 to 132 (pages 35-36), none of the other numerous examples in the Discussion Draft are directed towards financial services entities and businesses.

The Discussion Draft asks the following question (at Additional point 8, titled Financial Services Sector, on page 15):

Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?

Part II of the Discussion Draft deals with Potential Special Measures to address particular situations. In this context, Framework question 9 on page 40 of the Discussion Draft (posed in relation to all of the ensuing five options) asks:

Should certain sectors be excluded from the application of the measures? In particular, how should measures focussing on capital distinguish financial services activities where capital adequacy rules apply and where the amount of capital affects the amount of business that can be carried on?

Banks are different

Starting with the tax related work of the League of Nations in the first half of the twentieth century, and as reflected for decades in the work of the OECD, there has long been a recognition that the nature of business undertaken by banks warrants special consideration when developing both domestic and international tax rules.

Since the 1984 Report, special consideration for banks has been a feature of the OECD’s pre-BEPS tax work – especially in the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments noted further below.

In the BEPS context generally, the OECD is aware that special consideration needs to be given to banks, although much more work needs to be done. For example, the recent OECD Discussion Draft on BEPS Action 4: Interest Deductions and other Financial Payments, notes at para 203 that ‘Banks and insurance companies present particular issues that do not arise in other sectors’ and goes on to present some (very brief) discussion of the reasons why this is the case, and what special rules might be required for banks. The ABA has made a separate submission on that Discussion Draft.

**The OECD has already addressed risk in banks – extensively**

The OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (2010 Report) was a landmark achievement, coming after more than a decade of extensive work by OECD members and involving substantial consultation with the private sector, and in particular the banking industry.

As a result of the 2010 Report, a new Article 7 (Business Profits) of the OECD Model Tax Convention on Income and on Capital, and related Commentary were approved by the OECD Council on 22 July 2010. The 2010 Report is far more detailed than the Commentary on Article 7, however the 2010 Report is essentially incorporated by reference, with paragraph 9 of the Commentary stating: ‘The current version of the Article therefore reflects the approach developed in the [2010] Report and must be interpreted in light of the guidance contained in it’.

The 2010 Report contains four parts (and an Appendix and Addendum), including relevantly for current purposes:

- Part II: Special considerations for applying the authorised OECD approach to permanent establishments of banks;
- Part III: Special considerations for applying the authorised OECD approach to permanent establishments of enterprises carrying on global trading of financial instruments.

It is most important to note that Part III of the 2010 Report is not limited in scope and application only to permanent establishments. It will have relevance to the interpretation and application of Article 9 (Associated Enterprises) as well as Article 7. In this respect, paragraphs 3 and 4 of Part III (page 108 of the 2010 Report) provide as follows:

3. However, there have been changes in global financial markets that affect the global trading of financial instruments since the publication of the Global Trading Report (for example increasing use of credit derivatives). More significantly, since 1998 there have been changes in thinking about the taxation of PEs and especially the application of the arm's length principle of Article 7(2). This led to the development of the authorised OECD approach described in Part I of this Report. Further thinking has also been given to the application of the arm's length principle of Article 9 and the guidance on that principle in the OECD Transfer Pricing Guidelines (“Guidelines”) to a global trading business conducted between associated enterprises. Particular attention has been paid to the application of the profit split method, the assumption of risk and the evaluation of the reward for provision of capital.

4. Part III of the Report is therefore intended to update the issues and situations described in the Global Trading Report and to provide guidance on the application of both Articles 7 and 9 to global trading. Section B describes the scope of Part III by providing a definition of global trading and goes on to provide a functional and factual analysis of a global trading business. Section C discusses the application of the Guidelines to a global trading business conducted between...
associated enterprises. Section D discusses how the authorised OECD approach applies to a PE of an enterprise carrying on a business of the global trading of financial instruments ("a global trading PE"). (emphasis added)

The nature of all manner of risk within banks, and the resulting tax implications, is canvassed at great length in both Parts II and III of the 240 page 2010 Report.

That is, the OECD has already provided extensive, and relatively recent, transfer pricing guidance on the treatment of risk within banks and other financial services organisations in the 2010 Report. As noted above, critical parts of that Report also apply to separate entities and not just permanent establishments/branches.

Accordingly, it is not clear to the ABA why any further guidance on risk, in relation to the banking industry, is warranted. At the very least, it will be important to ensure that any changes to the TP Guidelines, as proposed by the Discussion Draft, are consistent with the 2010 Report.
February 6, 2015

**BEPS Actions 8, 9 and 10: Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures)**

Comments by the Banking and Finance Company Working Group on BEPS

**Introduction**

These comments are being submitted to the OECD by the Banking and Finance Company Working Group on Base Erosion and Profit Shifting (BEPS), a group of global banks and finance companies, in response to the OECD’s paper of 18 December 2014 entitled “BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (Including Risk, Recharacterization and Special Measures).”

We welcome the recognition in the Discussion Draft of the fact that risk and capital are core components of financial services businesses and that different guidance may therefore be needed for financial services (which is specifically noted in Question 8 in the “Additional Points” box in paragraph 40 on page 15 and Question 9 in the “Framework for questions on all options” box in the Special Measures section on page 40 of the Discussion Draft). This submission addresses these questions and also identifies particular aspects of the Discussion Draft that give rise to concerns for financial services businesses.

**The need for separate guidance in Chapter I for banking and finance businesses**

*The banking and finance business*

The assumption of financial risk from customers and the maintenance of adequate capital to support such risks are among the core components of the business of banks and finance companies. Their business must be conducted in accordance with country-specific regulations regarding the amount of loss-absorbing capital they must maintain, the amount of leverage they are allowed, their employees, and other critical aspects of their business.

We agree with statements in the Discussion Draft that banks and finance companies have special characteristics that must be taken into consideration in developing transfer pricing guidance.

---

1 The Banking and Finance Company Working Group is comprised of members of the Securities Industry and Financial Markets Association (including Citigroup, T.D. Bank, JPMorgan Chase & Co., Bank of America, State Street, BNY Mellon, and Goldman Sachs), and General Electric and American Express. The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to develop policies and practices which strengthen financial markets and which encourage capital availability, job creation and economic growth while building trust and confidence in the financial industry. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information and a complete list of SIFMA members, visit [www.sifma.org](http://www.sifma.org)
related to risk and capital. Similarly, financial regulators, in considering how to ensure the safety and soundness of financial institutions, must keep in mind these same special characteristics.

At the most basic level, financial institutions use debt to fund financial intermediation between investors/savers and borrowers. Financial institutions incur interest expense on their liabilities – funds borrowed from either depositors or debt holders – and receive revenue from their interest-earning assets (e.g., home mortgage loans, credit card loans, auto loans, farm loans, repurchase agreements, etc.). In this way, financial intermediation channels capital throughout the economy. In their intermediation role, financial services companies take on the risk of default by borrowers and, often, take on interest-rate and currency risk.

The regulation of financial services business should and does take into account the role of risk and capital

Financial regulators balance the fact that financial services businesses need to assume financial risk with concerns regarding safety and soundness. The financial services industry is highly regulated with numerous capital requirements intended to address leverage and excessive risk-taking.

Banks and other financial institutions have long been required to hold a minimum absolute amount of loss-absorbing capital and, beginning in the 1980s, to maintain minimum capital-asset ratios as well as leverage ratios. The Basel Accords instituted credit risk adjustments to capital-asset ratio requirements in 1992. The Market Risk Amendment and Basel II introduced additional controls for both market and operational risk, as well as the requirement for value-at-risk modeling, which estimates the potential for asset loss over a period of time.

The financial crisis led to a reexamination of capital requirements, debt-to-equity ratios, bank supervision standards, the role that risk plays in operating and managing regulated financial institutions, and the manner in which failures of systemically significant financial institutions will be managed if another financial crisis occurs so as not to create contagion in the global economy. Following the financial crisis, the Basel Committee developed the Basel III standards aimed at improving the banking sector’s ability to absorb economic crises, improve risk management and governance, and strengthen banks’ transparency and disclosures.

For more information on regulation as it impacts financial services, see the Appendix.

In summary, the nature of the financial services business and existing and evolving regulatory requirements surrounding capital and risk result in considerable safeguards against BEPS in the industry.

- The financial services regulatory framework requires that customer-facing activity be conducted in regulated entities with a focus on where the customers are located. Regulators closely monitor the activities of financial institutions and impose restrictions on the ability to transfer capital to foreign subsidiaries.
- Regulators are imposing new capital standards aimed at preventing another financial crisis, including mandates on the amount of capital and loss absorbing debt, and how that
additional capital and certain other loss-absorbing instruments should be positioned at the holding company level and in affiliates.

- Creditors and rating agencies provide a second line of defense: they create a powerful incentive to prevent financial institutions from separating risk, risk management, and capital in different group entities.
- Finally, global financial institutions do not yet know all of the different levels of regulatory capital that global regulators will require, and what form that regulatory capital can take.

Existing transfer pricing guidance for banking and finance groups

The OECD has spent considerable time and effort to understand the functions and value chain of the banking business in developing bespoke guidance for the allocation of risk and capital within banking groups. The OECD had extensive discussions with the industry during the development of guidance to Article 7 of the OECD Model and preparation of the OECD Part II\(^2\) report. This report applies the authorized OECD approach in order to allocate risk and capital to the respective parts of a bank by reference to people functions. OECD Part II, and its subsequent adoption into domestic laws and tax treaties, is widely regarded by both tax authorities and taxpayers as a reasonable and fair approach to taxing banking and finance businesses.

The principal value-creating functions in banking and finance, as set out in OECD Part II,\(^3\) are the creation of financial assets and the subsequent management of risk associated with those assets. These Key Entrepreneurial Risk Taking (“KERT”) functions are described as “most relevant to the attribution of economic ownership” of the financial assets.

In other industries, there is not necessarily a correlation between the location of risk and capital within an MNE group, i.e. there may be risk in an entity but not capital, and vice versa. However, for banks and finance companies, risk acceptance and capital normally must go together, as capital is the means by which the impact of risk can be mitigated. This is recognized in paragraph 66 of the Discussion Draft (“MNE groups, unless subject to capital adequacy regulations, can determine the capital structure of subsidiaries without explicit consideration of actual risk in that subsidiary.”) Notably, the analysis of banking and finance in OECD Part II includes a thorough discussion of the role of capital and capital management.

Because regulators limit the ability of a bank or finance company to shift risk to an affiliate lacking appropriate capital and people functions, the arm’s length principle will generally cause income to be allocated for tax purposes to the appropriate entity within a banking or finance group. As is explained in OECD Part II, the KERT functions in a bank or finance company—namely, the creation of financial assets and management of the risk associated with those assets—drive the need to maintain capital to support the business and to employ staff who are qualified to perform the KERT functions. Under the transfer pricing analysis set out in OECD Part II, it is not possible to separate the KERT functions from the income attributable to the assets and risks that are thereby created and managed.

\(^2\) Part II of the OECD’s Report on the Attribution of Profits to Permanent Establishments (“OECD Part II”) (July 17, 2008 and 22 July 2010).
\(^3\) OECD Part II, Section B-1 (paragraphs 8-9).
Accordingly, we believe it is necessary to differentiate the banking and finance industry in Chapter I, Part D of the Transfer Pricing Guidelines in the same way as was done in the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (in which general Article 7 guidance was provided in Part I and the special analysis of banking and finance was provided in Part II).

**Particular aspects of the Discussion Draft of concern to the financial services industry**

*Separation of risk assumption and risk management*

The proposed guidance in Part 1 of the Discussion Draft contains numerous statements that are not relevant in the context of banking and finance. For example, statements about allocation of risk and profit to the party that has more control over the risk (e.g., in paragraphs 38, 39, 60, 61, and 72 of the Discussion Draft) are premised on the notion that it is possible for a group company to assume risks that it is unable to manage. As noted above, for a banking or finance group, applicable regulations will impose significant constraints on the ability of group members to allocate risk or capital in a way that is not aligned in substance with the performance of the relevant KERT functions.

More specifically, paragraphs 38 and 39 discuss the need to examine the conduct of related parties to a contract in identifying the actual allocation of risk between them. It is noted that in arm’s length dealings, unrelated parties generally will not agree to take on risks over which they have no control. Control over risk is described as the capability to make the decision to take on the risk and subsequently to decide whether and how to respond to the risk. The Discussion Draft indicates a concern that related parties may contractually allocate risk to a party that does not control the risk, because related parties “lack the divergence of interests” that exists between unrelated parties. In the context of banking and finance, this concern is mitigated by the fact that regulators generally require that a licensed lender have the independent capacity to perform the KERT functions discussed above.

Similarly, paragraphs 60 and 61 discuss allocating risk between related parties on the basis of the parties’ conduct, rather than on the basis of the contract between the parties. For the reason noted above in relation to paragraphs 38 and 39, it is difficult in practice under applicable regulations to have a divergence between the parties’ conduct and their contract in the case of related party transactions within a regulated financial services group. Paragraph 61 rightly contains an illustration of this point, by giving the example of car insurance purchased from an unrelated insurer and correctly stating that “the insurance company will have the relevant capabilities to assess, underwrite and manage the insurance risk.” The same is true of banks and finance companies, which are required to have the capabilities relevant to taking on and managing financial risk.

Paragraph 72 concludes this section of the Discussion Draft as follows: “Circumstances meriting particular scrutiny include those where the transferee has no risk management capability, and those where risk management is performed by the transferor.” Again, in the context of a banking
or finance group, such circumstances typically cannot arise with respect to intra-group transfers of financial risk.

**Non-recognition**

The discussion of non-recognition in paragraphs 83 through 93 of the Discussion Draft maintains that tax administrators may consider non-recognition because the arm’s length standard when applied to certain taxpayer arrangements discussed in the Draft is not applicable from a pricing perspective because the transactions do not have arm’s length attributes. The Draft explains that this phenomenon is due to the fact that, as is explained in paragraph 86, “Except in certain regulated sectors, MNE groups have freedom to control their structures, including shareholding, capitalization, and legal form.” The Working Group recommends that the circumstances of regulated banking and finance groups, and the implication that non-recognition is not relevant for such groups, be stated more plainly. In other words, due to regulation, banking and finance groups do not have the freedom to structure their arrangements in the ways described in paragraphs 85 through 87 of the Discussion Draft. Consequently, the analysis in paragraphs 88 through 92 of the Discussion Draft is not appropriate for these groups.

**Potential special measures**

Regarding Part 2 of the Discussion Draft, which describes potential special measures for addressing residual BEPS risks in connection with intangible assets, risk, and over-capitalization, we are concerned that any tax rule that is inconsistent with the arm’s length principle may have adverse unintended consequences for the banking and finance industry. Our response to Question 9 on page 40 of the Discussion Draft is that the special measures considered in Part 2 are in general not necessary to prevent BEPS for regulated banks and finance companies.

Paragraph 3 on page 38 of the Discussion Draft mentions “the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities,” referred to in the Discussion Draft as “MFEs.” This does not apply to banking and finance groups, which must allocate their capital to the operating companies in the group that take on financial risk and must employ staff who are qualified to perform the KERT functions discussed above.

Option 1 would permit tax authorities to presume the existence of a price adjustment mechanism in a related-party sale of a hard-to-value intangible. We are not aware that hard-to-value intangibles play a significant role in the business of banking and finance groups.

Options 2 and 3 address “Inappropriate returns for providing capital.” Option 2 is aimed at situations in which a company owns assets that are managed by a related company. Under this option, the income from the assets would be allocated for tax purposes to either the management company or the parent company of the group. Option 3 is conceptually similar: it targets companies with “excess capital” and would allocate the income attributable to such capital to the shareholder who invested it by deeming the investment to be an interest-bearing loan.

Options 2 and 3 describe fact patterns that generally would not exist in a banking or finance group, due to regulatory requirements, rating agency considerations, and the business incentive
to manage capital efficiently so that it supports as much lending business as possible. However, in the absence of more detail regarding these options, we cannot be certain that they would not produce inappropriate results if applied by tax authorities in the context of banking and finance groups. We are concerned, therefore, that attempts to apply these options to banks and finance groups could result in a misalignment and consequent business distortions.

Option 4 would reallocate all of the profits of an entity that has minimal functions. As in Options 2 and 3, the reallocation would be either to related parties who are managing the relevant assets or to the shareholder who provided the assets to the minimally functional entity. Option 4 appears to have little relevance to banking and finance groups because it is premised on the existence of significant profits in a minimally functional entity, which is difficult to achieve in the new regulatory environment for financial services groups. However, these groups may be subject to regulations that effectively require group services to be housed in an unregulated company that deals only with affiliated entities, performs mainly routine functions, and may have a small number of employees. Such a company would normally earn only a small profit margin under the arm’s length principle, but the Working Group is concerned that a reallocation of profits could occur under the option regardless of the true function of the entity.

Option 5 would reallocate so-called excess returns that are subject to a low effective tax rate to the group parent company under controlled foreign company rules. Excess returns would consist of profits associated with intangibles and risk, with an exception for profits representing “normal returns on capital invested in real activities within a jurisdiction” and “local income from sales or services to unrelated persons” in the company’s country of residence. This appears to be similar to certain U.S. tax proposals in recent years, including a proposal in President Obama’s FY 2016 budget relating to international tax reform, and a proposal to impose a U.S. minimum tax on certain foreign source earnings relating to the exploitation of intangibles in tax reform legislation introduced in 2014 by then US House of Representatives Ways and Means Committee Chairman Dave Camp. We have a number of concerns about this potential special measure:

- If the definition of excess returns is focused on returns from intangibles, the formula for isolating these returns would need to be carefully designed. For service industries, including the financial services industry, any test of “normal” returns based on investment in tangible business assets would be inappropriate because most of the income produced by the business would relate to non-tangible assets, including people functions.
- Similarly, the definition of an “allowance for corporate equity” that provides an exemption for “normal returns on capital invested in real activities within a jurisdiction” would need to recognize that capital invested in real activities can take forms other than tangible capital assets such as machinery and equipment.
- Further, a test based on whether the CFC’s customers are located in the CFC’s country of tax residence would be difficult to meet in regions such as Europe, where EU legislation facilitates regional, cross-border activity within the EU countries.

The secondary rule mentioned at the end of the description of Option 5 needs to be outlined in more detail. Allocating the CFC’s excess returns “to other jurisdictions based on a pre-determined rule” is too vague to comment on at this time.
We also note that Option 5 appears to be more appropriate for consideration by the OECD in connection with its work on strengthening controlled foreign corporation regimes, as opposed to inclusion in the Discussion Draft (which relates to transfer pricing).

Overall, we are concerned that the special measures options would depart from existing OECD guidance on the application of the arm’s length principle to transactions within MNEs. For banking and finance groups in particular, the OECD Part II guidance already allows tax authorities to look at economic substance (i.e., the performance of the KERT functions) in determining appropriate transfer pricing results. In addition, the domestic tax laws of many countries include a general anti-avoidance rule that deals with the BEPS issues targeted by the special measures options in the Discussion Draft. Therefore we recommend that these options be revised so as to target potential BEPS issues that are not otherwise addressed already in OECD transfer pricing guidance or the domestic tax laws of OECD/G20 member countries.
Role of capital requirements

The financial services industry is highly regulated with numerous capital requirements intended to address leverage and excessive risk-taking (Table 1). The Basel Committee on Banking Supervision, consisting of banking supervisory authorities worldwide, sets prudential regulatory standards for banks worldwide and provides a forum for cooperation among banking regulators.

Banks and other financial institutions have long been required to hold a minimum absolute amount of capital, and beginning in the 1980s, to have minimum capital-asset ratios. The Basel Accords instituted credit risk adjustments to capital-asset ratio requirements in 1992. The Market Risk Amendment to Basel II introduced additional controls for both market and operational risk, as well as the requirement for value-at-risk modeling, which estimates the potential for asset loss over a period of time.

The financial crisis led to a reexamination of capital requirements, debt-to-equity ratios, bank supervision standards, the role that risk plays in operating and managing regulated financial institutions, and the manner in which failures of systemically significant financial institutions will be managed if another financial crisis occur so as not to create contagion in the financial services industry.

In 2008, the G20 committed to fundamental reform of the global financial system. “The objectives were to correct the fault lines that led to the global crisis and to build safer, more resilient sources of financier to serve better the needs of the real economy. National authorities and international bodies, with the Financial Services Board (FSB) as a central locus of coordination, have taken forward this financial reform program, based on clear principles and timetables for implementation.”

In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in 2010 and called for increases in capital requirements for both U.S.-based banking groups and non-U.S.-based banking groups operating in the United States. The Act did not include specific capital requirements in order to allow coordination of potential increases in capital requirements with Basel III, which was then being negotiated.

Following the financial crisis, the Basel Committee developed the Basel III standards aimed at improving the banking sector’s ability to absorb economic crises, improve risk management and governance, and strengthen banks’ transparency and disclosures.

Accordingly, the Federal Reserve in 2014 announced rules to implement Dodd-Frank and Basel III, which will impose a new 4.5% Tier 1 common risk-based ratio and increase the Tier 1 capital ratio requirement to 6%. In addition, the new rules include a 2.5% common equity Tier 1 capital to risk-weighted assets conservation buffer bringing the total requirement to 7%. Failure to meet the conservation buffer – insufficient common equity Tier 1 capital – would result in limitations on allowable discretionary payments and shareholder distributions. The Federal

---

Reserve estimated that 95% of insured depository institutions are already in compliance and have Tier 1 common risk-based ratios above the 7% minimum.

Table 1. Evolution of capital requirements

<table>
<thead>
<tr>
<th>Year</th>
<th>Regulation</th>
<th>Key provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>Basel I</td>
<td>Required capital-asset ratios include adjustments for credit risk and off-balance sheet assets. Implemented 8% total capital to risk-weighted assets requirement and 4% requirement for Tier 1 capital.</td>
</tr>
<tr>
<td>1996</td>
<td>Market Risk Amendment</td>
<td>Amended Basel I to account for market risk and adopted value-at-risk modeling.</td>
</tr>
<tr>
<td>2005</td>
<td>Basel II</td>
<td>Incorporated operational risk into the risk adjustments for assets.</td>
</tr>
<tr>
<td>2010</td>
<td>Dodd-Frank</td>
<td>Called for enhanced capital requirements but deferred specifics to regulators to allow flexibility in Basel III negotiations.</td>
</tr>
<tr>
<td>2013</td>
<td>Basel III</td>
<td>Included a new 4.5% common equity Tier 1 capital requirement, increased minimum Tier 1 capital ratio from 4% to 6%, kept 8% total capital requirement, included a 4% leverage ratio for all banks and a 3% supplementary leverage ratio for advanced-approaches banks, and imposed a 2.5% common equity Tier 1 capital conservation buffer</td>
</tr>
<tr>
<td>2014</td>
<td>FSB proposals on TLAC</td>
<td>The FSB proposes to require G-SIBs to hold additional regulatory capital and other loss absorbing instruments in amounts sufficient to recapitalize in the event of resolution. The proposal could require equity and loss-absorbing debt approximately double the amount of equity capital required under Basel III.</td>
</tr>
</tbody>
</table>


Along with establishing significantly enhanced bank capital requirements, Basel III also introduced leverage ratio requirements that act as a credible backstop to the risk-based capital requirements. Basel III requires all banks to maintain a minimum leverage ratio, defined as the ratio of Tier 1 capital to average total consolidated assets, of at least 4%. Some banks are subject
to a separate supplementary leverage ratio of at least 3%. The leverage ratio is intended to restrict the build-up of leverage in the banking sector and captures both on- and off-balance sheet sources of banks’ leverage.\

Most recently, global regulators have focused on heightened capital and liquidity requirements as well as regulatory and supervisory restrictions on risk taking designed to reduce the risk of failure by systemically significant financial institutions. For example, global regulators have issued proposals relating to the need for “Total Loss-Absorbing Capital” (TLAC), including certain types of debt, to be maintained by global banks. The FSB’s consultative document, released November 10, 2014, sought comments on proposals to require global systemically important banks (G-SIBs) to hold regulatory capital and other loss absorbing instruments in an amount sufficient to recapitalize a G-SIB in resolution.

The proposal is another step on the part of international banking regulators to develop a regulatory framework aimed at preventing the insolvency of financial institutions by allowing the resolution of G-SIBs without imposing losses on taxpayers or creating systemic destabilization.

Like other similar initiatives, the proposal to require sufficient levels of TLAC is expected to be adopted as part of laws and regulations in key jurisdictions. Most relevant for purposes of this BEPS discussion is that the TLAC proposal calls for TLAC in a combination of debt and equity capital both to be issued at the holding company level and to be “pre-positioned” in regulated affiliates around the world. A key feature of this initiative is to allow for the recapitalization of G-SIBs, including their subsidiaries in different jurisdictions, by providing an essential cushion of loss absorbing common equity and debt after the base of Basel III minimum regulatory capital has been eroded. The amount of TLAC required will be substantial, with the FSB proposal contemplating combined debt and equity approximately double the level required under the Basel III minimum capital standards.

The FSB has indicated it will not issue final TLAC standards until November 2015, and global implementation is not anticipated prior to 2019, but certain jurisdictions may seek to implement the TLAC requirements more quickly through their own laws and regulations.

---

5 Basel III Leverage Ratio Framework and Disclosure Requirements, the Basel Committee on Banking Supervision, January 2014
February 6, 2015

Mr. Andrew Hickman
Head of Transfer Pricing Unit, CTPA
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

Email: TransferPricing@oecd.org

Re: Comments on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures)*

Mr. Hickman,

This submission relates to the Public Discussion Draft BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation and special measures) (“Discussion Draft”). Pursuant to the OECD invitation to comment, please find attached a non-comprehensive list of preliminary comments.

We would also like to take this opportunity to thank the OECD for indicating modifications in the paragraphs as this has rendered the review of the Discussion Draft much more efficient.

Please contact Sebastien Rheault (514-982-6148; s.rheault@barsalou.com) or Sheena Bassani (514.982.2306; s.bassani@barsalou.ca) should the OECD desire further elaboration on these submissions or that these or related discussion items be presented at the meetings scheduled in March 2015.

Sheena Bassani, Of Counsel
Member of the Quebec Bar Association
Sebastien Rheault, Partner
Member of the Quebec Bar Association

*Please take note that the attached comments have been submitted in the personal names of the undersigned and may not represent the views of Barsalou Lawson Rheault.
# Table of Contents

I. Executive Summary ............................................................................................................................... 3  

II. Introduction .......................................................................................................................................... 5  

III. Comments and Suggestions .................................................................................................................. 5  

   A. In Breach of the Arm’s Length Principle .......................................................................................... 5  
      1. Different Risk Preferences ............................................................................................................ 5  
      2. Special Measures ........................................................................................................................ 10  

   B. Examples Where Clarity has been Compromised ........................................................................... 14  
      1. Unnecessarily Complicating the Analysis .................................................................................... 14  
      2. Questioning Business Judgment of the Taxpayer ....................................................................... 15  

   C. Fundamental Questions about the Discussion Draft and Direction of BEPS ............................... 15  
      1. The Role of Tax Incentives from Tax Authorities ........................................................................ 15  
      2. Centralized Global Fiscal Control ................................................................................................ 16  
      3. The Need for Transitional Measures .......................................................................................... 16  

IV. Conclusion ........................................................................................................................................... 17
I. Executive Summary

In Breach of the Arm’s Length Principle

We believe that it is the OECD’s responsibility to uphold and protect the arm’s length principle. Suggestions to equate the risk preferences of related enterprises in a group puts the arm’s length principle at risk.

In our view, a transaction should not be disregarded unless it can be determined that it would not have been entered into by arm’s length parties and that the transaction can reasonably be considered not to have been entered into for a bona fide purpose other than to obtain a tax benefit. Downsides would greatly outweigh any benefits, if the OECD Guidelines were to attempt to prescribe certain behavior through special measures.

We do not believe special measures that go beyond the arm’s length principle are necessary to address the identified challenges. However, if the OECD nevertheless proceeds with such measures, it is critical that they be as limited in scope as possible. Tax authorities have been discussing amongst themselves the harmful tax regime practices that have led to the current situation; removal of any harmful tax regime practices should be sufficient to curtail the transactions that tax authorities find most unacceptable, without having to resort to special measures. Additionally, tax authorities could make greater efforts to be current in their audits, and to review certain transactions on a current or timely basis if they view them as particularly problematic (e.g., hard-to-value intangibles).

Any special measures that the OECD insists on implementing would have to be rigorously analyzed to determine if they are absolutely necessary. In all cases, they should be couched in terms such that they would not apply if: no tax benefit in fact results from the transaction OR if the transaction was carried out primarily for bona fide purposes other than to obtain the tax benefit. It would also be important to preserve the possibility of seeking relief from double taxation even in the event that the taxation arises from a special measure. This is all the more true in a context where tax authorities have coaxed businesses to move certain operations to their countries through their tax incentives, and now suddenly the rules are to be changed/retracted and what was once an invitation would now be treated akin to tax avoidance. The mutual agreement procedures must therefore be opened up and expanded to include all instances where special measures have been applied. Furthermore, in the event that a special measure applies a non-arm’s length result to a transaction, for entities who are routinely/commonly entering into those transactions with third parties as a part of its business operations (loans for banks, as an example), exceptions should be established to exclude those enterprises from the application of any such special measures.

We would like to see an expedited special mutual agreement procedure available to taxpayers who are facing grave and imminent harm resulting from special measures. Also, a simplified rulings procedure
would be helpful, to simply confirm whether a taxpayer’s facts fall within the contemplated special measure or not (offered for example through the mutual agreement procedure).

Examples Where Clarity has been Compromised

Some points in the Discussion Draft seem to unnecessarily complicate the analysis. For example, with respect to employee secondments, the guidance seems to lead to a potential proliferation of transactions without leading to greater reliability or even a different net result.

The Discussion Draft further suggests that a party cannot assume a risk it does not control, nor one that a related party has more influence over; however these positions are untenable under the arm’s length principle.

In some paragraphs, the Discussion Draft opens the pathway for questioning the business judgment of the taxpayer. This would not serve to advance the objectives of the OECD. The wording in this draft modifies the prior text to require taxpayers to only enter into transactions “if they see no alternative that offers a better opportunity to meet their commercial objectives.” However, the main question should be whether this special measure reduces uncertainty for the taxpayer and the tax authorities alike. In this case it is questionable, as the modification seems, if anything, to further blur the lines of what may have led to a bright line test if modifications had gone in the other direction.

Fundamental Questions about the Discussion Draft and Direction of BEPS

There is concern that the analysis and measures proposed by this Discussion Draft may be going too far, from complete fiscal freedom of the nations with commitment to common-sense arm’s length principles and optional treaty arrangements, towards a model of centralized global fiscal control with a potential web of arbitrary special measures and deviations from the arm’s length principle.
II. Introduction

The Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation and special measures) (“Discussion Draft”) contains a number of well-presented thoughts, ideas and analyses. There is, however, concern that the analysis and measures proposed by this Discussion Draft may be going too far, from complete fiscal freedom of the nations with commitment to common-sense arm’s length principles and optional treaty arrangements, towards a model of centralized global fiscal control with a potential web of arbitrary special measures and deviations from the arm’s length principle.

The comments and suggestions below are divided into three parts. Part A addresses the concern that some aspects of this Discussion Draft are in breach of the arm’s length principle. Part B exposes examples where we question whether the draft guidance offered is perhaps counter-productive to the objective of bringing greater clarity. Part C revisits the fundamental questions and concerns about the somewhat aggressive approach taken by this Discussion Draft.

III. Comments and Suggestions

A. In Breach of the Arm’s Length Principle

1. Different Risk Preferences

On page 13 of the Discussion Draft (Additional Points), mention is made that issues in Sections D.2, D.3, and D.4 tend to involve the extent to which associated enterprises can be assumed to have different risk preferences while they may also in fact be acting collaboratively in a common undertaking under common control. Just as there is a fundamental difference between a subsidiary and a PE, so too associated enterprises can and do have different risk preferences.

Some are more entrepreneurial in nature, and others are more oriented towards execution of tasks. Some are actively engaged in managing certain types of risks with third parties whereas others are not. For example, the distribution division of a parent company may have employees who enter into complex agreements with third parties, and therefore has employees who focus on assessing the risks, pricing those risks, monitoring those risks, and recommending action when risks are realized. On the other hand, a distribution company of the same group located in another smaller foreign jurisdiction would not have such employees on staff, does not enter into such agreements with third parties, and therefore assumes none of the aforementioned responsibilities. To equate the risk preferences of the two entities would do irreparable harm to the arm’s length principle.

Associated enterprises necessarily have different risk preferences, and even in looking at their functional capacities, it is obvious that they are not all capable of assuming certain types of risks.
The Discussion Draft on p. 13 and following invites us to consider certain elements when providing comments. We comment on each of these items below.

**a. Moral Hazard**

The Discussion Draft indicates moral hazard to be the “lack of incentive to guard against risk where one is protected from its consequences”. Although this concept is of interest and somewhat informative when analyzing arm’s length behavior, it is not sufficiently flexible to accommodate the wide range of relationships that arm’s length parties enter into. For example, insurance contracts are specifically designed to transfer moral hazards from one party to another. And although there is some risk mitigation that can be done through clever contractual caveats, the main risks that will be most likely to materialize are simply not within the control of the insurer. Further, there are many instances where parties will accept to assume the risks of another party if they are not significant relative to their profit potential in entering the overall arrangement. For example, accepting to reimburse costs to a party may include a trust component that costs will be reasonable and that the expenditures will achieve the desired outcome. Sometimes limits can be imposed contractually as between the parties to provide some protection from abuse, but in many cases, parties would trust one another and be content knowing that it makes more sense for any overruns to be borne by the party who has the most upside, even if it is not within the control of the latter party.

It is important to continue to adhere to the arm’s length principle and avoid creating black-and-white thinking about risk matters. Par. 44 describes a transaction where the manufacturer (whose functional currency is USD) charges for goods in euros (the functional currency of the purchaser, the distributor), but where the contract attributes exchange risk to the distributor. It concludes that the aspects of the contract do not reflect actual commercial or financial relations between the parties. However, if the parties perform a year-end analysis of the transfer pricing applied between the parties, and if significant foreign exchange losses were incurred by the manufacturer, which were charged back to the distributor at year-end, as per an unwritten contractual agreement (or as per their transfer pricing policies as documented in their TP study), then the correct delineation of the transaction would include exchange risk assumed by the distributor.

Similarly in par. 45, reference is made to the importance of looking to see where inventory write-downs are taken. However, even if the taxpayer domestically takes the deduction, as it related to assets on its balance sheet, it is easy to envisage situations where the taxpayer should not be considered as ultimately assuming the obsolescence risk. For example, the taxpayer cannot be considered as the one ultimately assuming obsolescence risk if it were to be reimbursed for this write-down, either specifically or else on a portfolio basis netted against the other transactions that should be analyzed together, or if the transfer pricing policy accounts for calculation of that risk and netting against other TP adjustments. Many taxpayers have adopted practical policies, and rather than implementing a proliferation of agreements, they focus on adjusting for certain elements through the transfer price or through the year-end TP adjustment. Such taxpayers should not be penalized for their practicality.

**Question 1:** The Discussion Draft questions what role, if any, imputed moral hazards and contractual incentives should have with respect to determining the allocation of risks and other conditions between
associated enterprises under the arm’s length principle. Although the concept of moral hazards may be somewhat illuminating in certain contexts, it does not serve the analysis well to attribute a greater importance to it than it deserves. The analysis ultimately should still be grounded in real life transactions, and if arm’s length parties would be willing in fact to assume risks that are not within their control, then the guidance provided in the OECD Guidelines cannot go against that without doing damage to the arm’s length principle.

**Question 2:** The Discussion Draft also questions how the observation in par. 67 (that unrelated parties may be unwilling to share insights about the core competencies for fear of losing IP or market opportunities) affects the analysis of transactions between associated enterprises. Perhaps a better question is why it should affect the analysis at all. Performance guarantees are real life examples where third parties require that another party assume risks associated with the performance of someone else’s obligation. Although the performance guarantee could be provided by another enterprise capable of executing the obligation itself (e.g., a parent company), it could also be reduced to a monetary insurance amount, and as such, be given by a bank in the form of an amount payable in the event of non-performance of the obligation.

**Question 3:** The question regarding the example in par. 90 and 91 is perhaps overlooking a very fundamental point. In that example, the trademark is transferred from Company S1 that is said to now be “subject to additional risk in that it is reliant on another party, Company S2… being willing to license the trademark to it and not to take actions which might enhance value for itself but potentially detract from Company S1.” However, this overlooks the fact that third parties may be afforded some protection in many jurisdictions by commercial (duty to protect the business) or civil/tort law, and that the seller would also have had the opportunity to contractually protect itself. Therefore, in the context of the arm’s length principle, moral hazard implications should only provide, if anything, a simple shift of the burden of proof such that one should not be at risk for non-recognition of a transaction just because a moral hazard is assumed by one of the parties. Rather, it is important to question why that moral hazard was assumed, and what other protections may be afforded to third parties seeking to transfer risk for such moral hazards.

**b. Risk-Return Trade Off**

**Question 4:** The Discussion Draft asks “Under the arm’s length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognised, how should they be treated?” In our view, a transaction should not be disregarded unless it can be determined that it would not have been entered into by arm’s length parties and that the transaction can reasonably be considered not to have been entered into for a bona fide purpose other than to obtain a tax benefit. Downsides would greatly

---

1 An example could be the seller of an electricity repair business who expects to receive interval payments over the next 5 years as the business continues to operate. If the purchaser sets up a shop offering the exact same service next door, and siphons off all the clients from the purchased business, then closes the doors of the acquired business after the first year, it has very likely breached one or more obligations. The seller in this instance would likely have the benefit of certain protections pursuant to commercial and possibly civil/tort and/or contractual law, and would not be left without any remedy.
outweigh any benefits, if the OECD Guidelines were to attempt to prescribe certain behavior through special measures. Firstly, OECD members should not seek to crystalize and encapsulate their view of arm’s length behavior. Even if it is believed by OECD member countries that a particular conduct is not in accordance with the arm’s length principle in 2015, it does not mean that it will be the case in five or ten years from now. Indeed, one of the main advantages of the arm’s length principle is that it evolves naturally within the marketplace, without having to constantly issue and revise prescribed rules.

Secondly, domestic tax legislation is generally based on the arm’s length principle. Introducing special measures within OECD Guidelines will not legally trump the arm’s length standard under domestic law (unless such measure are incorporated into domestic law across all jurisdictions, through for example a multilateral instrument and coordinated changes to the laws of the countries). This would introduce considerable risk, complexity and uncertainty for taxpayers and tax administrations alike. For example, if taxpayers were to follow the OECD’s eventual special measures and if these measures are later determined by a tribunal not to be consistent with the arm’s length standard based on locally observed conduct, then they may be at risk of transfer pricing penalties and could see their transactions revised by a tribunal. Conversely, if a local tax administration disregards a transaction based on OECD Guidelines, without meeting the requirements of local legislation, these measures will only result in controversy and be reversed on appeal after years of litigation. Indeed, domestic legislation often contains precise legal requirements for recharacterization. In Canada, the Canada Revenue Agency cannot legally circumvent the pre-requisites found at paragraphs 247(2)(b) and (d) of the Income Tax Act. These provisions authorize the Minister to recharacterize a transaction or series so as to modify “amounts”, for tax purposes, but only if there are clear indications that the transaction or series would not have been entered into by arm’s length parties and if the transaction or series can reasonably be considered not to have been entered into for a bona fide purpose other than to obtain a tax benefit. Not recognizing transactions on the basis of “special measures” will likely run afoul of such legislation.

Furthermore, we question whether creating prescriptive special measures would prevent an MNE from transacting with group members the same way in which they could transact with third parties. We also question whether this outcome could risk placing MNE’s at a disadvantage in the marketplace, as they would not have the same flexibility as other enterprises dealing at arm’s length.

We understand there is a multilateral treaty that is being contemplated to implement some of the BEPS strategies, but even if special measures are implemented through such an instrument, there are potentially large downsides. It is not clear how courts would interpret the instrument, how the special measures would ultimately co-exist with the arm’s length principle as enunciated in the Guidelines and domestic legislation, or whether special measures would just lead to greater complexity in analysis and uncertainty in outcome.

Examples: Reiterating what is mentioned above relative to moral hazards, there are in fact examples in the real world where third parties will enter into transactions, the sole purpose of which is to shift risk. Insurance contracts are the perfect example. Another obvious and very common example is the sale of a business – for an investor who is not an owner-operator, s/he pays cash to the seller and assumes the risks (including upside and downside monetary potential) of the business so acquired. Additionally, in
the context of typical buy-sell or services transactions, if one party has the most to gain in terms of profit potential, it may make more sense to attribute certain other risks to that party, even if it doesn’t mean there will be more profits available to compensate if they are realized.

_Treatment:_ To summarize, transactions whose sole purpose is to shift risk must be recognized pursuant to the arm’s length principle if it is conceivable that third parties would similarly shift risks. It is not necessary to create new rules to address this, as we believe the framework is otherwise addressing the practices that the tax authorities feel are unacceptable.

**Question 5:** Regarding the example in par. 90 and 91, the asset transfer shifts only some risks from Company S1, the original owner of the trademark, to Company S2. Notably, par. 90 indicates that the royalty payable to S2 by S1 for licensing of the trademark, would only represent the value of a financing return. If this is meant to limit the value of what is transferred to the time value of money, then other risks associated with poor sales evolution or the sudden loss of value of the trademark should not be considered. However, given that S2 now owns the trademark, and in fact has disbursed $400M to purchase it, if the trademark no longer generated sufficient returns to pay the expected royalties, or suddenly became worthless (e.g., a major and irreparable defect is discovered in the product), the sales basis upon which the royalty is applied may dwindle and thus the expected financing return would not be recouped. Even if S1 had contractual obligations to pay minimum royalty payments, S2 may have a difficult time collecting any funds from S1 if its business no longer has a stable source of operating profits; if however the initial lump sum was retained and invested, then these funds would still be available for repayment as a (minimum) royalty to S2. In this example, we can see that the transfer of the asset shifts more than just the time value of money, it has also shifted some of the operational risks to S2, although perhaps this is what is meant by a larger definition of “financing return”.

**Question 6:** Risk-return trade-off implications can be taken into account through an analysis of how much profit was foregone in exchange for lesser risks. It is important to understand which risks are retained and which are transferred, as suggested above.

**Question 7a):** Perhaps it could be appropriate to read into the question replacing the word “transactions” with “transactions or reassessments”. Obviously manipulating and plugging discount rates would not be proper, the same way cherry picking comparables in a benchmark would not be proper. However, incorrect application of methods by some taxpayers or tax authorities does not justify draconian special measures to address it. A simple solution could be encouraging tax authorities to become current in their audit cycles such that they can audit the valuation in real time or before the expected benefits are realized. If that is not possible and reporting requirements are viewed as necessary to flag certain types of transactions to the tax authorities, those needs could be easily accommodated in the OECD’s current work in that area, and would lead to a better result than creating non arm’s length special measures that increase uncertainty and the risk of double taxation.

**Question 7b):** There is no need to go beyond the arm’s length principle as techniques used between unrelated parties can be applied to ensure the desired policy outcome (e.g., contractual undertakings, minimum royalties, etc.). Going beyond the arm’s length principle will necessarily become the
application of an arbitrary rule, since there is no intuitive or common-sense approach to defining the criteria for such special measures.

2. **Special Measures**

We do not believe special measures that go beyond the arm’s length principle are necessary to address the identified challenges. However, if the OECD nevertheless proceeds with such measures, it is critical that they be as limited in scope as possible.

**Question 6:** For example, following similar general anti-avoidance rules, as explained above, they should be couched in terms such that they would not apply if: no tax benefit in fact results from the transaction OR if the transaction was carried out primarily for bona fide purposes other than to obtain the tax benefit. In Canadian transfer pricing legislation, this has been stated as, “the transaction or series: can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit”.

**Question 8:** Also, it would be important to preserve the possibility of seeking relief from double taxation even in the event that the taxation arises from a special measure. The reason is because transfer pricing rules have become increasingly complex, and there will continue to be many cases where the authorities do not come to the same conclusions as the taxpayers and would have resort to a special measure, without the good faith of the taxpayer being called into question. This is all the more true in a context where tax authorities have coaxed businesses to move certain operations to their countries through their tax incentives, and now suddenly the rules are to be changed/retracted and what was once an invitation would now be treated akin to tax avoidance. The mutual agreement procedures must therefore be opened up and expanded to include all instances where special measures have been applied.

**Question 9:** Furthermore, in the event that a special measure applies a non-arm’s length result to a transaction, for entities who are routinely/commonly entering into those transactions with third parties as a part of its business operations (loans for banks, as an example), exceptions should be established to exclude those enterprises from the application of any such special measures. Otherwise the company/group would have an unfair burden in this respect and absurd pricing arrangements could result.

**Question 10:** We would like to see an expedited special mutual agreement procedure available to taxpayers who are facing grave and imminent harm resulting from special measures. Also, a rulings procedure would be helpful, to simply confirm whether a taxpayer’s facts fall within the contemplated special measure or not.

---

*a. Option 1: Hard-to-Value Intangibles (“HTVI”)*

This measure seeks to introduce a rebuttable presumption that arm’s length parties would have in fact imputed a contingency payment mechanism into their agreement.
**Question 1:** This measure could achieve closer alignment between transfer pricing outcomes and value creation in those instances where value has been created by the seller but not sufficiently remunerated by the buyer. However, it is not clear that this requires going beyond the arm’s length principle. On the contrary, the option that is proposed could well be crafted to fit within the arm’s length principle, and so we urge the OECD to not go beyond the arm’s length principle as it pursues and develops this special measure.

**Question 2:** This special measure aims to make it easier for the tax administration to propose reassessments on the basis of actual outcome (coupled with a contingency payment mechanism). The primary advantage of this measure is that it could be adapted to fit within an arm’s length analysis (with some modifications). Disadvantages include the lack of clarity as to how the tax administration would determine imputed contingency payments, and the arbitrary nature of the threshold above which the projections/profit must not deviate, which calls into question the necessity and usefulness of introducing special measures from the outset. Also, the other situation cited to rebut the presumption appears at current to be an unrealistic requirement as valuation experts would not likely disclose the confidential information of its clients, even if it had such in its possession, to prove that s/he has a track record of making such projections reliably in the past in similar circumstances. Consequently, more work should be put into defining the situations where the presumption could be rebutted.

**Question 3:** The likely effect of such a measure will be to require compliance and reporting. The behavior it could foreseeably change would be to encourage taxpayers to routinely consider including contingency payments in their agreements. On the other hand, the measure may not be effective if it simply results in taxpayers including a contingency payment, as disputes may then focus on the sufficiency of the contingency payment mechanism rather than the purchase price, and no clarity has been gained in the process.

**Question 4:** More situations should be elaborated where the presumption could be rebutted, and it should be clearly stated that where the *ex ante* analysis is demonstrated to be in compliance with the arm’s length principle the presumption shall not apply. Rather than approaching it as it is written (presumption relying on special measure, only to be rescued by a rebuttal), it could be more easily incorporated into an arm’s length analysis by starting with the transfer pricing documentation expectations for such transactions, coupled with any special reporting requirements, and closed with a prompt review by the tax administration so that the analysis can be tested and agreed before hindsight comes into play.

**Question 5:** With improvements on clarity, the measure may well target the focus of its application. For example, the first two bullet points should be clearly set out as cumulative, and not alternative criteria. Clarification could also be provided on what is meant by making the projections “available to the tax administration” (upon request, etc.).

The second last bullet mentions the relevance of the experience of making projections reliably. This reference would also require clarification, as it is not clear whether the relevant experience is that of its advisors or of the company itself through its personnel. It however appears to introduce an element of
uncertainty, which reduces the utility of applying a special measure. If the valuation is not robust, this should become apparent when the analysis is being audited. Establishing the track record of the valuation professional appears to be overkill.

It is also necessary to clearly define what is meant by “hard to value”. There is concern that too many intangibles could be captured by an overly-broad definition, especially if there are a different set of rules that will apply to such “hard to value” intangibles. Also, perhaps a strict time limitation could be placed on the period during which this special measure could be applied by tax authorities (so as to avoid hindsight reassessments).

**Question 6 and 7:** We believe that all special measures, including this one, should include criteria limiting the measure to circumstances where the arrangements result in a tax advantage to the group (see above). On the other hand, this will not be necessary if the measure disposes of its non-arm’s length aspects and focuses only on the arm’s length parameters.

**Question 8, 9 and 10:** See general comments above.

**b. Option 2: Independent Investor**

This option is draconian. An in-depth analysis of the potential impact of this measure should be carried out before proceeding any further. It alone has the potential to demolish corporate structures, and weaken economies that would be most touched by such measures.

The lack of transitional measures becomes even more patently obvious in this context. An MNE who finds itself in a structure that is targeted by such a special measure will be faced with a transitional nightmare. It must determine, among others, how it can realign its activities, how long that will take, what its options are, how much it will cost, and whether it will be at risk of non-recognition of the necessary restructuring transaction that ensues because the required restructuring leaves the MNE worse off financially than before or because it requires the transfer of only risks.

**c. Option 3: Thick Capitalisation**

**Question 1:** The Thick Capitalisation measure will certainly reduce the attractiveness of capitalizing entities that are targeted by this measure. Whether it achieves the policy goal is dependent on whether the level of capitalization can be defined and determined in such a way as to not interfere with capitalization of the entities where value is to be created.

It is unclear under this option whether the intent is to preserve the ability of groups to create/maintain IP holding entities in their structure or whether the OECD seeks to reduce or eliminate that practice. We understand that work is underway currently at the OECD analyzing in what instances patent box regimes constitute harmful tax practices. Presumably there will be interaction between that work and this measure.

**Question 2:** A disadvantage would be the significant risk of introducing an element of arbitrariness into the process. The great challenge for this option, will be in determining the appropriate level of capitalization. Using a group ratio or a fixed ratio would be an entirely unacceptable result, and does not
grant recognition to the fact that each business has different capitalisation needs, and cannot be assumed to have the same needs or preferences. How to determine those varying needs may not be a straight-forward task.

**Question 3:** The likely effect of this measure will be mainly as a deterrent. However, the initial rolling out of the measure could be problematic. A major issue in complying will be the economic considerations of moving money out of certain jurisdictions so quickly. Significant foreign exchange gains or losses could be triggered, intercompany agreements could be broken, etc. The potential impact and special transition measures should be considered.

**Question 4:** We understand that the OECD has a number of initiatives underway or imminent that may interact with this measure. Consideration should be given to aligning this special measure with a safe harbour rule on interest.

**Question 5:** The measure targets the focus of its application like a bull’s-eye. However, there are a number of areas lacking clarity. For example, capitalization may include stock, long term debt and retained earnings. It would be important to define which of these elements would be captured by this option. If retained earnings are meant to be captured by this rule, it would be important to identify which entity would be attributed the deemed interest (i.e., the company contributing the funds or the company to whom the funds would be paid out as a dividend). Applying the rule to retained earnings could cause problems, such as when, for foreign exchange reasons, or due to uncertain future business expenses, it is not an ideal time to pay out retained earnings as a dividend, but the remaining cash would get captured by this thick capitalisation measure.

If the company has long term debt, questions arise as to whether that debt is already subject to interest, if so, whether a lower rate than the special measure otherwise provides should apply for that portion, and which entity would be attributed the deemed interest. If such additional deemed interest “tops up” the interest already payable on the long term loan, it is questionable whether the parties would still need to document the arm’s length rate of the interest applied initially to the loan, as the effect of the special measures in that instance appears to act more like a safe harbour on the loan.

If the entity to which the rule would apply is the tested party in the context of a benchmarking study, it would be important to understand the significance of the level of capitalisation of the comparable companies relative to the tested party.

**Questions 6-10:** See comments above.

d. **Option 4: Minimal functional entity**
We reiterate our comments expressed above under the Independent Investor header and general comments at the outset of this section.

e. **Option 5: Ensuring Appropriate Taxation of Excess Returns**
We reiterate our comments expressed above under the Independent Investor header and general comments at the outset of this section.
B. Examples Where Clarity has been Compromised

1. Unnecessarily Complicating the Analysis
   
   a. Employee Secondments
   Paragraphs 1.95 and 1.96 of the Guidance on Transfer Pricing Aspects of Intangibles, issued in 2014, raise the possibility that seconded employees may lead to the transfer of intangibles. This possibility is again reiterated in the Discussion Draft, at par. 7 [new], although the guidance does little to clarify circumstances that would lead to such transfer. However, read in conjunction with the guidance in the Discussion Draft, it is important to question whether these new rules and analyses are not just creating a proliferation of non-existent transactions to consider, doing little to improve the clarity or reliability of the analysis.

   For example, consider an IP owner who concludes a contract with a subsidiary (SubCo) to perform contract manufacturing, and the former provides several employees on secondment to SubCo to help get the manufacturing up and running according to company standards and to teach local officers how to manage the various risks associated with the manufacturing such that these would not be passed along to the distributors. In this example, instead of just benchmarking SubCo for its contract manufacturing activities, the new guidance urges us to consider the manufacturer as the entity attracting the outcome of upside and downside risk (see paragraphs 57 and 60 for example). However, we are also instructed by par. 7 to consider the value of the transfer of the IP to the manufacturing subsidiary. However, the net effect of these two transactions would logically result in SubCo receiving remuneration consistent with that of a contract manufacturer, given that the value of the transfer of any IP should reflect the profits that could be generated from the new activity and thereby cancelling out one another on a net basis (aside from contract manufacturing remuneration which would remain with SubCo). Given this example of circular analysis and the complexity and unreliability that would be introduced by having to proceed in such a manner to analyze the overall transactions, it leads us to question the necessity of such rules altogether.

   b. Control of Risk
   The Discussion Draft says at par. 61 that “To the extent that ability to control a risk is lacking in a group situation, then the arrangements would not support the contractual allocation of that risk for transfer pricing purposes.” As indicated previously, there are examples in the real world where risk is attributed to a party who cannot control the risk but who can exercise some management over that risk (e.g., insurance).

   Similarly, certain market risks are also something that neither party can necessarily be in control of, but the risk itself could be allocated to either party or both depending on the propensity to take on entrepreneurial risk.
We cannot emphasize enough the importance of not proscribing asset owners from assuming risk or from having the right to receive the upside from that risk just because the risk is not one that can be controlled (par. 63). If third party asset owners can be observed assuming such risks or if it is in line with what could be reasonably expected from arm’s length parties desirous of entering into such a transaction, then the arm’s length principle commands us to permit those transactions.

2. Questioning Business Judgment of the Taxpayer

   a. A “Better” Opportunity to Meet their Commercial Objectives?

Paragraph 12 of the Discussion Draft [1.34 modified] changes the previous guidance in a way that could encourage improper questioning of the business judgment of the taxpayer.

In analyzing options realistically available to them, it is expected under the current guidance that taxpayers would “only enter into the transaction if they see no alternative that is clearly more attractive.” This has been modified to require taxpayers to only enter into transactions “if they see no alternative that offers a better opportunity to meet their commercial objectives. In comparing one option with another, independent enterprises consider any differences between the options that would significantly affect the potential to meet those objectives.”

We question how tax authorities would proceed to determine what would be a “better opportunity.” Furthermore, this raises question as to whether companies retain the right to change their commercial objectives. It seems that this would open a can of worms with uncertainty around how many options must be considered (all of them, some of them, within their own industry or beyond, etc.). The consideration of realistic options may require expensive valuations exercises, and third parties do not generally proceed with such an exhaustive review of their available alternatives (many third parties would value the relationship with a sole supplier so much that they are consciously willing to pay more to retain the relationship than risk an uncertain new business relationship). This guidance, unless it is significantly improved to bring more certainty, may be inadvertently opening the door to breach of the arm’s length principle through questioning the business judgment of the taxpayer and imposing unrealistic options on the taxpayer in the guise of realistic options.

The main question should be whether this “improvement” reduces uncertainty for the taxpayer and the tax authorities alike. In this case, it is questionable, as the modification seems, if anything, to further blur the lines of what may have led to a bright line test if modifications had gone in the other direction.

C. Fundamental Questions about the Discussion Draft and Direction of BEPS

1. The Role of Tax Incentives from Tax Authorities

We understand that G20 Leaders have endorsed a solution on how to assess whether there is substantial activity in an intellectual property regime, and this solution involves allowing a taxpayer to
receive benefits on IP income that are in line with the expenditures linked to generating the income. We understand that transitional provisions for existing IP regimes have also been agreed.

A pertinent question would be whether we can expect that regional, provincial or state taxing authorities will also be pulled into the ambit of the work that is being done to require substantial activity in their territory before granting the promised tax incentives. If so, which implementation problems would the OECD foresee? In Canada for example, a province who has not signed a treaty would not be bound by the tax treaty signed by the federal taxing authority.

It is unclear whether there are broader discussions underway amongst the tax authorities regarding the prevention of “harmful tax regimes” at source (i.e., by eliminating the tax incentive to set up the companies’ operations in ways that are not considered desirable by the tax authorities). To the extent that such measures would be serving potentially overlapping purposes as those contained in this Discussion Draft, it would be helpful for those suggestions to be circulated to business as well, to invite discussion on it, and to re-evaluate the necessity of some of the new approaches and special measures in this Discussion Draft as a result.

2. Centralized Global Fiscal Control

There is concern that the analysis and measures proposed by this Discussion Draft may be going too far, from complete fiscal freedom of the nations with commitment to common-sense arm’s length principles and optional treaty arrangements, towards a model of centralized global fiscal control with a potential web of arbitrary special measures and deviations from the arm’s length principle.

Many questions come to mind:

- What effective checks and balances have been considered?
- Are there anti-competitiveness issues with this new global approach?
- What is the potential impact of implementation of such drastically different rules (could these measures drive any MNEs into bankruptcy protection, result in mass company closures, lay-offs, etc.)?
- Will any countries be placed in financial distress due to a hasty implementation of new rules?
- Has the OECD calculated the estimated economic impact (apart from the expected tax impact) of implementing such rules, for countries, companies and individuals?
- What transitional measures have been considered in implementing these rules?

3. The Need for Transitional Measures

There is a serious need to consider transitional measures due to the potential significant impact of any such new rules.
If we take the example from par. 44, assuming it would not make sense for the manufacturer to bear the foreign exchange risk, and that the parties proceed to execute an agreement to transfer that risk back to the distributor in an effective way (i.e., changing for the goods in USD instead of euros). However, if special measures are also implemented to prevent transactions where the sole purpose is to shift risk, this becomes a “catch 22” and the distributor ends up with a windfall result whereby it is exempted from a risk it would normally have had to bear. Transitional measures could prevent these situations from arising.

IV. Conclusion

It is hoped that these submissions will assist Working Party No. 6 in their efforts to further refine the guidance offered in this complex area of risk, recharacterisation and special measures.

Further and more in-depth discussions on these and other connected topics are always welcome.
BDI comments on the Discussion Draft on BEPS Actions 8, 9 and 10:
Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)

Dear Mr. Hickman,

BDI\(^1\) refers to the OECD Discussion Draft “Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)” issued on 19 December 2014. We would like to thank you for the possibility to provide our comments that allow us to engage with you on these important issues. Before commenting on some of the specific provisions we would like to outline some preliminary thoughts.

General Comments

We support the OECD’s work to assure that transfer pricing outcomes are in line with value creation. We agree with the Discussion Draft’s recognition that the delineation of transfer pricing transactions must follow the business reality, encompassing actual conduct and actual allocation of risk and that contractual terms should reflect this reality. The mere contractual allocation of risk is not acceptable under the arm’s length principle.

We welcome the augmentation of the existing guidance on risk given in Chapter I of the OECD Transfer Pricing Guidelines. Whilst we welcome clarification in this area we would note that extending the TP-Guidelines to improve clarity in respect of risk is a rather different purpose from targeting Base Erosion and Profit Shifting. Therefore, it should be clarified that the purpose of the measures included in Part I is to provide additional guidance to tax payers on how to perform the functional analysis consid-

\(^1\) BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 36 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related service.
ering the risk factor and its treatment under normal circumstances, in or-
der to correctly delineate transactions, rather than avoiding BEPS.

In this context, we would like to note that the examples given in Section
D1 cover standard scenarios and do not represent situations where con-
tractual terms are ambiguous, incomplete or incorrect. The proposed
measures should not result in an increase of recharacterisation of the
transactions already analysed by businesses.

Regarding the potential special measures included in Part II, we would
like to point out that the examples included refer to very specific and lim-
ited related transactions in which there arises a BEPS situation. These are
not the general rule in the majority of the MNEs related party transac-
tions.

The analysis of commercial and financial relations, together with (if ne-
cessary) the application of non-recognition rules, should be considered
enough to guarantee a proper remuneration of the intragroup transactions
within MNEs. Therefore, we consider that there would be no need for
these special measures in order to avoid BEPS behaviour.

However, in case special measures are finally approved, they should be
applied consistently by all tax administrations in order to avoid an in-
crease of tax disputes and potential double taxation.

Specific Comments

- Identifying the commercial or financial relations (D.1.3.): With
  regard to the reference to “communication between the parties
  other than written contracts” it must be ensured that no additional
disclosure requirements of internal communications are intro-
duced. Tax Authorities must not be encouraged to ask for any kind
on communication.

- Identifying the commercial or financial relations (D.1.5.): With
  regard to the contracts mentioned in the first sentence, it must be
  ensured that the burden of proof is not altered. The contracts must
be deemed as reflecting reality until proven different by the Tax
Authorities, not the other way around.

- Identifying the commercial or financial relations (D.1.12.): The
  assumption underlying the paragraph is that independent enter-
prises are always rational and factually have full information
about their environment. This is often not the case. Also, the que-
ston arises as to how this can be translated into the intercompany
transfer pricing design without creating ex-post criteria.

- Identifying risks in commercial or financial relations (D.2. Addi-
tional Points – Moral hazard): While it is true that an entrepreneur
would like to avoid any hazards that he cannot control but are in
control of someone else, it must be taken into account that there
are a lot of industries where some players do not have any chance
but to accept such risks. Thus, it is not always the case that third
parties will only accept risk if they can incorporate safeguards or incentives into contractual arrangements. Apart from this, the problem with the concept of moral hazard is also a very real one: following that concept, a low risk intercompany service provider or low risk manufacturer would always receive a small, positive remuneration even if the whole industry it operates in is loss making. This reflects neither the reality between independent parties, where the low risk entity might well be prepared to work for zero-margin or even contribution margin only instead of going out of business altogether, nor does it do justice to a MNE that makes losses throughout its whole supply chain for a longer period of time.

Therefore, although moral hazard exists in certain third party transactions, it does not exist in all. It is therefore very difficult under the arm’s length principle to know when moral hazard should be imputed in a group context.

- Identifying risks in commercial or financial relations (D.2. Additional Points – Risk-return trade-off, No. 7, questions a) and b)): We have a general issue with the approach that is implied here as this assumes that there are objective criteria available (e.g. discount rates, future returns) to determine whether a MNE tried BEPS. These do not exist. There will never be certainty on this in a tax audit.

Please do not hesitate to contact us if you have any questions.

Sincerely,

Florian Holle  
Dr. Karoline Kampermann
Ms Marlies de Ruiter
Head, Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA
2 rue Andre Pascal
75775 Paris
France

6 February 2015

Dear Ms de Ruiter,

DISCUSSION DRAFT ON BEPS ACTIONS 8, 9 AND 10: REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERIZATION, AND SPECIAL MEASURES)

BDO welcomes the opportunity to comment on the OECD’s Discussion Draft issued on December 1, 2014 on “BEPS Actions 8, 9 and 10: Revisions to Chapter 1 of the Transfer Pricing Guidelines (including risk, recharacterization and special measures)” (the “Discussion Draft”).

We agree that there is a need to assure that transfer pricing outcomes are in line with value creation within all Multi-National Enterprises (“MNEs”). We concur with the general direction of the proposed Guidelines in the Discussion Draft and have kept the OECD’s objectives in mind when drafting our comments and responses to the specific questions raised by the OECD.

We set out our comments, responses and suggestions below:

OVERALL

The Discussion Draft does not represent a significant departure from the historic intentions of the Guidelines, but rather reaffirms and emphasizes expectations. Overall, this should be helpful as it sets out clear expectations for both MNEs and tax authorities. However, by increasing emphasis on certain areas and by making the concept of non-recognition more explicit outside of the context of recharacterization in Chapter IX, there is a risk that this will increase the expectations for documentation and tax authority challenge across the board rather than simply focusing on the higher risk, hard to characterize or potentially inappropriate transactions which we understand are the OECD’s main concern. The OECD might usefully consider increasing the level of practical guidance around how the new level of proposed scrutiny is implemented, placing this in the context of their Risk Assessment Handbook and their other recent moves towards simplification in certain areas.

On the same theme, it would be helpful for the OECD to clarify the similarities or otherwise between non-recognition in the Draft and recharacterization in Chapter IX. There is room for overlap between the concepts; however the different terminology could lead to uncertainty.
SPECIFIC COMMENTS

Section D.1

Paragraph 3

Acknowledging that communications other than formal intercompany agreements are acceptable is helpful and could reduce administrative requirements.

Paragraphs 4 and 5

Establishing the need to review the conduct of the parties over purely legal form or pricing policy is consistent with the arm’s length standard. However it would be useful to provide guidance on how tax authorities might assess this. The overall requirement suggests a more in-depth review of the terms and delivery of transactions which may not be consistent with the process in the OECD’s Risk Assessment Handbook, unless a very high-level approach, based on the data in a country by country report is to be used. When this is addressed elsewhere in the document, such as in paragraphs 16 and 37, the level of information required is consistent with full transfer pricing documentation at a minimum.

Paragraph 5

This paragraph alludes to the bargaining power of the parties to a transaction. Bargaining power can often be difficult to quantify and/or demonstrate. Guidance on what could form acceptable supporting evidence could alleviate uncertainty for MNEs preparing documentation and/or responding to an enquiry.

Paragraphs 9 and 10

The discussion of economically relevant characteristics is a good introduction. Explicit reference to the later sections on risk, and, in particular, the management of risk, would be helpful to ensure this is not interpreted in isolation. A consideration of that risk management in the context of concepts such as SPF and KERTs in the Attribution of Profit to PE work could be beneficial.

Paragraph 12

The implication is that the OECD is suggesting that consideration of ORA is required for every transaction. Meanwhile there is reference to some activities being essentially standard, such as distribution. In view of this there is a concern that some tax authorities may seek this additional level of analysis for all transactions, including those such as management services which carry lower risk. This could add significantly to documentation requirements and the requisite analysis. The OECD might be more specific about the existence of standard or routine transactions and suggest that this kind of analysis is expected in cases of higher risk, hard to value transactions or where there could be reasonable uncertainty of the arm’s length nature of the transaction.
Paragraph 14

It would be helpful to clarify to OECD’s expectation around the adjustment to comparable data, such as the use of working capital adjustments versus the analysis of an appropriate point in a range of comparable data. The OECD may want to comment on how its guidance in paragraph 14 is to be interpreted in conjunction with paragraph 26.

Paragraph 19

We are concerned that the OECD is recommending the recognition of “implicit support” provided to one company by other companies in the group, i.e., diversification that is implicit in the insurance premium charged by an independent insurer is already provided by the group companies. This appears to deviate from the arm’s length principle, in that the OECD Guidelines have always been based on two related companies transacting at amounts, and on terms and conditions, which would exist between two unrelated companies. Recognizing any “benefit” from being part of a group of companies is a direct contradiction of the arm’s length principle that is “the” foundation for the OECD Transfer Pricing Guidelines.

Section D.2

The overall discussion in this section could be interpreted as movement towards a world of transfer pricing using the Profit Split Method. The OECD may want to make more reference to its guidance on comparability and testing in this context to show that, for example, the Cost Plus Method or the Resale Price Method can be consistent with the proposals in the draft.

Paragraph 46

It should be emphasized that management may be a core operational function that is not always co-located with execution of an activity.

Paragraphs 49 to 53

In the discussion of respective risks, the OECD may usefully expand on how to treat the concept of exclusivity as this is a more common feature in associated entities than third parties. This has a bearing on risk, but for both sides.

Also around this point there is discussion of moral hazard. This is a good area to dwell on, but how does it compare to the ultimate entrepreneurial and financial risks?

Paragraph 92

Where a tax benefit is identified, this should not necessarily be a red flag. Costs may need to be reviewed on a multiyear basis to gain a full picture of a (new) arrangement as any tax benefit may be recognized more quickly than any commercial or financial benefits.

Paragraph 93

Can the OECD clarify the impact of non-recognition? Is this always non-recognition of the whole transaction or, where that transaction is made up of identifiable component parts, could “line-item non-recognition” that alters the nature of one of those component parts be an acceptable option for a taxing authority?
OECD QUESTIONS

Moral Hazard

As stated in the Discussion Paper, Moral Hazard “refers to the lack of incentive to guard against risk where one is protected from its consequences” and it “is used ... to introduce the concept that unrelated parties would seek to avoid moral hazard that may arise in situations where one party assumes a risk without the ability to manage the behaviour of the party creating its risk exposure.” Moral Hazard “extends to the safeguards or incentives that unrelated parties may incorporate into contracts between them in order that interests are better aligned and moral hazard is reduced or avoided.”

1. In our experience, contracts between unrelated parties deal with moral hazard largely through the use of termination clauses combined with clearly delineated clauses dealing with the obligations of both parties and the responsibilities of both parties. Such contracts also state clearly those acts/actions that are considered unacceptable (again, usually in the termination clauses). The same types of clauses are evident in contracts between related parties, with the added safeguard of the oversight of the contractual arrangement by the Parent Company in the group. As a result the role of imputed moral hazard and contractual incentives is minimal in respect of determining the allocation of risks and other conditions between associated enterprises.

2. In our experience, the fact that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities has minimal impact on the analysis of transactions between associated enterprises. Unrelated parties will share what is required to complete the work required under a contract. Related parties will likewise share what is required to complete the work required under a contract. In most cases, related parties are unwilling to share insights into core competencies or market opportunities.

3. The terms and conditions of the contract between S1 and S2 would be such that S2 would be required to obtain the “substance” required to promote and protect the trademark for which it is collecting a royalty from S1. The example at paragraphs 90 and 91 illustrate, to our mind, the need for the substance of a transaction between related parties to mirror the substance inherent in the terms and conditions required in a similar transaction between unrelated parties.

4. In any transaction between unrelated parties there is agreement on which party bears which risk. The return attributable to each party to the contract is determined, in part, on the performance of specific functions and, in part, on bearing certain specific risks. If a risk is shifted between two parties to a transaction, whether related or unrelated, then the return needs to be shifted in a manner that accurately reflects the true quantum of risk being transferred.
5. In the example at paragraphs 90 and 91, the asset transfer alters the risks assumed by
the two parties because the risk of ownership, maintenance and defence of the
trademark should rest with the owner of the trademark. In other words, S2 should
now bear the risk associated with the trademark, such as defending the trademark
against infringement.

6. As noted in our previous responses, S2 requires the substance to own, maintain and
defend the trademark to justify charging a royalty for it to S1.

7. Yes, the risk-return trade-off does apply generally to transactions involving, in part,
the shifting of risk. Further:
   a) There are limits to the extent the risk-return trade-off should be applied, in that
      the shifting of risk must be bona-fide, and the determination of appropriate
      returns must be made to correlate with the true economic impact of an entity
      bearing that risk.
   b) This may require analyses and documentation of the historical costs incurred by
      the entity bearing the risk before that risk gets shifted within the MNE.

8. In the financial services sector the same concepts apply, in that the party bearing the
financial risks must have the ability to effectively deal with the risks, mitigate the
costs associated with those risks, and bear the costs associated with the risks. In our
experience, there is already an increased emphasis on risks in the financial services
sector, with those risks being very specific and linked with the capital of a company
as presented in the Financial Statements.

For clarification of any aspects of this response sent on behalf of the BDO transfer pricing
network, please contact:

Paul Daly
Partner, BDO UK
paul.daly@bdo.co.uk
+44 11 8925 8512

Dan McGeown
National Practice Leader Transfer Pricing, BDO Canada
dmcgeown@bdo.ca
+1 416 369 3127

Anton Hume
Partner, BDO UK
anton.hume@bdo.co.uk
+44 207 893 3920

Duncan Nott
Director, BDO UK
duncan.nott@bdo.co.uk
+44 20 7893 3389
BEPS MONITORING GROUP

Comments on BEPS Actions 8, 9, and 10: Revisions to Chapter I of Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures)

This report is published by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This paper has been prepared by Jeffery Kadet and Sol Picciotto, with comments and input from Veronica Grondona, Attiya Waris and Yansheng Zhu.

We are grateful for the opportunity to contribute these comments, and would be happy to participate in the public consultation on this issue.

SUMMARY

We applaud this discussion draft (DD) as an attempt to reconsider the basic approach, which has too long dominated transfer pricing regulation, that taxation of a multinational corporate group must treat its various component parts as if they were independent entities and focus on the pricing of transactions between them. This independent entity assumption runs totally counter to the current reality existing within these centrally-managed groups, and produces a system which is terribly subjective, often very discretionary, and impossibly difficult to administer.

To examine the details of intra-firm transactions, this independent entity assumption requires tax administrations to use specialist staff, normally in short supply in developed countries and often non-existent in developing countries, with legal expertise in complex structures and transactions, economic analysis capabilities, and specific knowledge of the characteristics of each business sector.

Despite this willingness to reconsider the basic approach, the draft still clings to that mistaken independent entity assumption by continuing to require that inter-affiliate transactions should be the starting point. These transactions are then evaluated in terms of the functions performed, assets owned and risks assumed by the affiliated entities, and the draft attempts to analyse these three factors: Functions-Assets-Risks (F-A-R), especially Risks. The draft rightly recognizes that in an integrated multinational corporate group ‘the consequences of the allocation of assets, function, and risks to separate legal entities is overridden by control’.

We cannot agree more with this, since the greater competitiveness and generally higher profits of a corporate group operating in an integrated way derives from the benefits of synergy, so that the whole is greater than the sum of its parts. It is generally difficult or impossible to decide what proportion of the total profits to attribute to particular F-A-Rs within the various group members, especially when central control allows a multinational to transfer at its sole discretion intangible assets, functions, and risks amongst group members solely for purposes of tax minimisation.

Hence, we agree with the analyses in the draft, for example that concerning ‘moral hazard’, which suggests that a contract between associated enterprises in which one party contractually assumes a risk without the ability to manage the behaviour of the party creating its risk exposure is clearly a sham. Following the approach of the DD, this means that non-recognition or other adjustments must be made to appropriately interpret the actual
transaction as accurately delineated. Our preferred approach, however, is to begin from the assumption that contracts between associated enterprises cannot be likened to market transactions between independent parties, for that very reason, so that the starting point should be an assumption that contracts between related entities should be disregarded.

Our preference, as we have urged in our separate comments on another report, is that the profit split method should be regularized and systematized, by clarifying the methodology for defining the aggregate tax base to be split, and specifying definite concrete and easily determinable objective allocation keys for all commonly used business models, also including the principles for choosing such keys for new business models as they appear in the future.

Part II proposes some ‘special measures’ which could be applied in defined ‘exceptional circumstances’, which in effect attempt to deal with some of the gaping wounds of the current transfer pricing system. We generally support these as at least an improvement on current formulations: particularly Option 1 (Hard to Value Intangibles); Option 2, first variant (Independent Investor); and Option 4 (Minimum Functional Entity). While we support Option 3 (Thick Capitalisation), in our view it must not form part of the Transfer Pricing Guidelines but belongs in the rules on Controlled Foreign Corporations, which are being separately considered. We detail strong reasons for this view.

We consider that there is merit in the concept of Option 5 (Ensuring appropriate taxation of excess returns), but as presently described it would be counter-productive and only continue to encourage BEPS behaviour, particularly if $x\%$ (the defined ‘low-tax rate’) is below the general corporate tax rate in the home country and is both the trigger for application of the CFC rule and the rate of tax to be applied under the CFC rule in the home country of the MNE. We propose that the trigger for applying this Option 5 should be an average effective rate of tax defined as a percentage that is very close to the general corporate tax rate in the home country. In particular, we recommend that it be no less than 95% of that home country rate.

Overall, these amendments to the Transfer Pricing Guidelines, although extensive, would for that very reason make them even more complex, subjective, and, for the most part, impossible for most countries’ tax authorities to administer. These and other drawbacks mean that the overriding need at the present juncture is for rules which are easily administered and that provide results for taxpayers and countries that all regard as fair. In the immediate term, we therefore strongly urge a clear shift towards a systematised and regularised application of the Profit Split method. A next step is a fundamental reappraisal of the Guidelines, and a complete rewriting especially of chapter 1. It should begin by a reversal of the independent entity assumption and an acceptance of the principle that each multinational corporate group must be considered according to the business reality that it operates as an integrated firm under central direction.

1. **GENERAL REMARKS**

A. **The Basic assumption**

1. These proposals represent a long-overdue reconsideration of some of the foundations of the Transfer Pricing Guidelines. Part 1 proposes some considerable rewriting of chapter 1 of those Guidelines, while Part 2 puts forward some options for additional ‘special measures’ which at this stage are only broadly outlined. These proposals result from a realisation that the relations between related entities within a multinational corporate group are fundamentally different from those of unrelated firms in market transactions. There is and can be no ‘market’ in the normal sense within a business firm under common ownership or control, since the central characteristic of such firms is that their activities are coordinated...
and directed by central management. Certainly, different functions and activities will be assigned to various entities under their own management teams, whose performance will be incentivised and evaluated. However, such administrative systems are quite different from market mechanisms, since they are designed to ensure that the parts contribute to the greater good of the whole.

2. Unfortunately, the Transfer Pricing Guidelines start from the opposite assumption, based on what we believe is a misunderstanding of article 9 of the model tax treaty. This provision, dating from 1935, allows national tax authorities to adjust the profits of associated entities if ‘conditions are made or imposed’ between them which ‘differ from those which would be made between independent enterprises’. However, the Guidelines (para. 1.6) mistakenly assert that this provision requires that the profits be adjusted ‘by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances’ – the famous ‘arm’s length principle’. This suggests a focus on comparing the pricing of transactions between related enterprises with those in unrelated party contracts which is not required by article 9. They continue by saying that this means that ‘attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions’. This approach requires a detailed analysis of the nature of the activities of the relevant parts of an integrated corporate group and the relations between them, before any conclusion can be reached about whether and how they differ from those between unrelated parties engaged in similar activities and transactions. In our view this is mistaken, unnecessary and undesirable. Instead this should be reversed. The presumption must be that transactions between associated enterprises are irrelevant since they are never negotiated between independent entities dealing at arm’s length. The focus should directly be on the profit attributed to the local entity in relation to its activities, in comparison with those of the whole firm of which it is part.

3. The current discussion draft (DD) is essentially concerned with attempting to remedy the defects resulting from this mistaken assumption. However, it leaves untouched the first three sections of Chapter 1, which state and firmly entrench the assumption. Part 1 of the DD then proposes a rewrite only of section D. The result is to make the Guidelines contradictory and incoherent. Tax authorities are expected to begin by respecting the assumption that related entities should act as if they were independent, but then to challenge that assumption by investigating the actual facts and circumstances to understand the reality, in each and every individual case. Worse, the focus on transactions dictates that the starting point should be the contracts between affiliates (DD para. 3), but these must be ‘clarified and supplemented’ by identifying the ‘actual commercial or financial relations’ (para. 4).

---

1 Article 9 can be interpreted to imply the arm’s length principle, but this is not its literal meaning. Nor could such an interpretation have been intended when it was drafted, since it resulted from the well-known Carroll report for the League of Nations, which extensively examined national practices. Carroll found that where national tax authorities were dissatisfied by the level of profit reported by a local branch or subsidiary, they evaluated the profits by comparison with those of similar but independent local firms, or by considering the relative profits and costs of the affiliate and its parent. Thus, the focus was on the level of profit, and not on the pricing of inter-affiliate transactions on a transaction-by-transaction basis. The adjustment of such inter-affiliate transaction prices was simply the means of reaching what could be considered an appropriate level of profit. Furthermore, Carroll found that in a substantial proportion of cases tax authorities used ‘empirical methods’, consisting of applying a ‘normal’ rate of profit to an appropriate factor (e.g. turnover). Others (e.g. Spain) preferred ‘fractional apportionment’, on the grounds that this dispensed with time-consuming and intrusive audits, the substitution of often arbitrary figures, and taxation on the basis of largely imaginary accounts.
4. Applying this approach, a tax authority must choose either to accept the accounts and profits declared by the company concerned, or to embark on a detailed ‘facts and circumstances’ analysis. The focus of such an analysis is now understood to be the functions performed, assets employed and risks assumed by each entity. This focus on ‘functions, assets and risks’ (F-A-R) features at various points in the existing Guidelines, and was given more prominence in the proposed rewriting of chapter VI on Intangibles (see especially proposed section B2 (shaded) of proposed Amendments to Chapter VI released in September 2014). One would have expected to find clear statements of these three concepts in this proposed revision of Chapter 1. Instead, we find uncertainty and doubt. For functions, proposed Section D.1.1 begins by explaining the need for functional analysis, but then points out that:

‘an MNE group has the capability to fragment even highly integrated functions across several group companies to achieve efficiencies and specialisation, secure in the knowledge that the fragmented activities are under common control for the long term and are co-ordinated by group management functions.’ (para. 21).

In other words, separation of functions within an integrated firm is fundamentally different from functional specialisation developed by independent firms in competition. This essentially reverses the basic assumption of ‘independent entity’. For property, Section D.1.2 simply incorporates unchanged three existing paragraphs, which discuss the many characteristics which may make a material difference to the nature of an asset or service when deployed in an integrated firm. As regards risk, a substantially new Section D2 is proposed. On this, the DD asks a number of questions, focusing on ‘the extent to which associated enterprises can be assumed to have different risk preferences while they may also in fact be acting collaboratively in a common undertaking under common control’ (Box p.13). This suggests that there are fundamental doubts about the stated assumption, which indeed we share. These doubts will be elaborated in our response to those questions in section 2 of these comments. First we will make some further comments about the unsuitability of the underlying approach.

B. Unsuitability of ‘facts and circumstances’ analysis of functions, assets and risks

5. The drawbacks of the approach proposed should be self-evident. Firstly, the principles are muddied with on the one hand continued adherence to the separate entity principle, but on the other hand the recognition in many parts of this DD and others, that a holistic approach is needed to deal effectively with multinationals. This, of course, reflects their total freedom within our legal and tax environment to structure themselves through multiple entities with contractual relations and capital structures designed to minimize taxation. Consequently, virtually every multinational situation requires a time-consuming and highly subjective case-by-case ad hoc analysis. Such analyses are intrusive, and require detailed audits of the internal workings of complex businesses, based on detailed documentation and reviews of physical operations including product flows and what personnel are actually doing, which may be different from the relevant documentation. Although referred to as a ‘comparability analysis’, a more accurate term would be ‘non-comparability analysis’, since the inappropriate nature of the separate entity approach explained above will inevitably mean that, on close examination, relationships within a corporate group are not truly comparable to those between independent entities. The present DD indeed provides considerable new material discussing factors and considerations which it quite rightly points out mean that the formal legal structures of separate entities and contracts do not reflect the business reality. Para. 85 illustrates this eloquently by noting, in part:
... the ability of MNE groups to create multiple separate group companies, and to determine which companies own which assets, carry out which activities, assume which risks under contracts, and engage in transactions with one another accordingly, in the knowledge that the consequences of the allocation of assets, function, and risks to separate legal entities is overridden by control.

This makes it hard to understand why the draft continues to maintain that the starting point for the analysis should be those structures and contracts.

6. Secondly, this is an incalculable waste of human talent and resources. The approach is a significant cause of the exponential growth in the past two decades of the tax departments of large multinationals, not to speak of the legions employed by the major accounting, law, and other tax advisory firms also involved. If the firm’s advisers produce the detailed explanations and documentation of the way the business has been structured, the tax authority must decide whether to accept or challenge them. A challenge requires resource-constrained tax authorities to apply equally enormous resources involving both legal and business specialist knowledge of potentially a very wide range of businesses. This is daunting for any state, but it is of course a special challenge for developing countries, which can ill afford to devote the sophisticated specialist personnel and other resources needed to operate this highly subjective and nuanced methodology. Even the United States Internal Revenue Service was recently reported to have hired outside consultants at a cost in the millions of dollars to work on a transfer pricing audit of a major U.S.-based multinational corporation. The changes proposed in this DD will add to the complexity and sophistication of the analysis required, which will exacerbate this problem. The new section D.2 on risk alone will add forty paragraphs covering ten pages, containing sophisticated discussion of the nature of various kinds of business risk, to be taken into account by tax officials. The new draft chapter 6 on Intangibles, which still awaits further revisions, and uses the same F-A-R approach, is also extensive and complex.

7. Thirdly, consideration of business reality also demonstrates the unreliability and unsuitability of attributing profits to entities based on the functions performed, assets owned and risks assumed. The greater competitiveness and generally higher profits of a corporate group operating in an integrated way derives from the benefits of synergy, so that the whole is greater than the sum of its parts. Hence, if analysis of functions, assets and risks is used to attribute a ‘comparable’ profit to each of the parts, it will fail to capture all the profits, leaving some residual profit, often very substantial, in a low-taxed group member specifically structured by the multinational for this purpose. Take for example internet-based retailing by a multinational which operates websites aimed at customers in many countries in the local language, as well as order fulfilment and customer support, all through different affiliates. Customers are attracted by the combination of these functions: ease of purchase through a well-functioning website backed by customer support and data-mining of customers and their preferences, combined with rapid delivery from the locally-based distribution network. Another example is the pharmaceutical industry, which combines laboratory research, drug development including trials and approval, and extensive marketing efforts. Profitability largely depends on the successful integration of these functions, and cannot appropriately be attributed to one or another.

8. Finally, as noted above, the ad hoc analysis is inevitably terribly subjective. This makes it highly prone to generate conflicts, both between tax authorities and taxpayers, and among tax authorities when conflicts reach the MAP stage or in APA negotiations. This has indeed led to a rapid growth of international tax disputes, especially relating to transfer pricing, referred to tribunals in some countries, notably India. However, these court decisions are also ad hoc
and have not facilitated predictable and stable outcomes; by nature the decisions are based on specific factual situations such that there will seldom be any useful precedential value. Where a publicly disclosed court case is not involved, conflicts are usually dealt with by a relatively closed group of participants, who can develop shared understandings of what is acceptable, sometimes described as ‘cooperative compliance’. This places great pressure on the professionalism and probity of public servants, especially given the great imbalance of resources between tax authorities and large multinationals. It also lacks legitimacy, as shown by the widespread public concern about suspected ‘sweetheart deals’ resulting from discretionary rulings taken in secret. We only have to note the recent Luxembourg leaks scandal to understand the extent that multinationals have made use of such rulings.

9. **These drawbacks of the proposed system mean that the overriding need at the present juncture is for rules which are easily administered and that provide results for taxpayers and countries that all regard as fair.** This has been made very clear by developing countries in their feedback on the BEPS project. Some countries have developed their own more simplified systems, such as the Brazilian fixed margin method, or the ‘Sixth Method’ for commodity pricing (now the subject of another report in the BEPS project). Indeed, some of the other reports being produced in the BEPS project have now proposed simplified methods. Unsurprisingly to us, these are based on the recognition that in business terms a multinational corporate group operates as a unified firm. Thus, a ‘simplified method’ for apportionment of charges for central services has been proposed, although this is understandably limited to low-value-added services, since other such charges can be used for profit-stripping. A more comprehensive approach has also been proposed for apportionment of interest costs, which we consider could be an enormous step forward in dealing with this intractable problem in a relatively simple manner. These several instances deal with apportionment of consolidated costs, which is perhaps easier to accept, especially for the home countries of multinationals, than apportionment of profits. Proposals have nevertheless also been put forward for developing the Profit Split method and expanding its use. However, these are so far cautious and limited, apparently intended only for special cases. As we have urged in our separate comments on that report, the profit split method should be regularized and systematized, by clarifying the methodology for defining the aggregate tax base to be split, and specifying definite concrete and easily determinable objective allocation keys for all commonly used business models, and including as well the principles for choosing such keys for new business models as they appear in the future.

10. For these reasons we can give only a very limited welcome to this report since, although it identifies many of the difficulties caused by the separate entity principle, it does not clearly articulate an alternative. In our view, what is needed is a fundamental reappraisal of the Guidelines, and a complete rewriting especially of chapter 1. It should begin by a reversal of the presumption and an acceptance of the principle that each multinational corporate group must be considered according to the business reality that it operates as an integrated firm under central direction.

2. **Specific Comments**

**Part 1 Questions**

*Under the arm’s length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?*

We agree with and support the articulated concept of moral hazard and the point that contracts between unrelated parties aim to place risks in the hands of the parties that control
those risks. The DD rightly states that between associated enterprises ‘the existence of common control will generally mean that there is no need to contractually align incentives in order to ensure that one party will not act contrary to the interests of the other’. The reason given, that ‘associated enterprises may act collaboratively in order to ensure that MNE group profits are maximised’ is understated. Entities within an efficient and well functioning integrated MNE must always act collaboratively to maximize overall profits, and their managers are generally incentivized to do so. Hence, a contract between associated enterprises in which one party contractually assumes a risk without the ability to manage the behaviour of the party creating its risk exposure is clearly a sham. Following the approach of the DD, this means that non-recognition or other adjustments must be made to appropriately interpret the actual transaction as accurately delineated. Our preferred approach, however, is to begin from the assumption that contracts between associated enterprises cannot be likened to market transactions between independent parties, for that very reason.

**Question 2**

*How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?*

This is clearly another good reason to doubt the validity of a purported transfer of risk in contracts between related entities. In our view it is pointless to begin by considering such contracts; they should simply be disregarded. If an approach based on analysis of functions, assets and risks is to be adopted, such an analysis should be applied directly to the activities of the entities concerned.

However, we also doubt the usefulness of attempting to attribute profits based on such an analysis of functions, assets and risks. This new section is replete with reasons to doubt the validity of any purported transfer of risks within an integrated MNE. Since associated enterprises always collaborate with the overriding objective of maximising total group profit, it should be assumed that any purported transfer of risk which carries an attribution of profit is designed for BEPS purposes.

This question points at simply one more reason why many more related party situations should be using the profit split method. In a separate comment letter responding to the *BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains*, we have strongly recommended the use of the profit split method applied with concrete and easily determinable objective allocation keys to allow all countries to better deal with BEPS issues and otherwise difficult transfer pricing problems. Firstly, this approach would be much easier to administer. Secondly, it is clear that any allocation of profits of a complicated corporate structure that results from a theoretically correct and complete assessment of functions, assets and risks will by its inherently subjective nature only result in a very wide range of possible profit allocations. The use of simple-to-apply concrete allocation keys that are appropriate for the particular business model used will result in profit allocations that will virtually always fall within this wide range. The reduction in BEPS behaviour, the ability of tax authorities in all countries to actually administer and collect taxes, and the reduction in conflicts will result in a much more robust and effective system.

We recommend:

- Where the discussion within the Guidelines dwells on highly subjective issues such as relative risk, the relative contributions of different intangibles, etc. (i.e, highly
subjective situations with no useable comparables available), that mention be made
that a profit split method may be the most appropriate one to apply.

Question 3

In the example at paragraphs 90 and 91 how should moral hazard implications be
taken into account under the arm’s length principle?

We agree that the moral hazard found within the example is a part of the reason why the
discussion of the example in paragraph 91 concludes that the “sale and license back”
transaction should not be recognized under the non-recognition rule. We applaud the
recognition of “moral hazard” in the discussion draft as a possible indication that a
transaction lacks the fundamental economic attributes of arrangements between unrelated
parties. This is one more reason why, as we argue in section 1 above, the starting point should
be an assumption that contracts between related entities should be disregarded.

Question 4

Under the arm’s length principle, should transactions between associated enterprises
be recognised where the sole effect is to shift risk? What are the examples of such
transactions? If they should be recognised, how should they be treated?

We believe that the answer is an emphatic “NO”. Contractual risk shifting between
associated enterprises is typically tax motivated and will often run counter to what unrelated
enterprises would do.

MNEs have full control over their structuring. Paragraphs 85 – 87 summarize in excellent
fashion the total freedom that MNEs possess within our legal and tax environment to
structure themselves through multiple entities with contractual relations and capital structures
fine tuned to minimize taxation within the jurisdictions within which they operate. The
following brief summary is from paragraph 87:

‘…MNE groups can control the environment in which transactions occur, including
the number of separate legal entities, their capital structures, legal ownership of
assets, and contractual arrangements, and … the resulting transactions derive from the
environment created by the MNE group…’

With this sort of freedom to fine tune the taxable position that they wish to present to each tax
authority, there is no reason whatsoever to allow a contract to be recognized that simply shifts
risk and that serves no purpose but to manage the profitability level of each group member.

Again, this is further evidence that our section 1 overall recommendation should be pursued.

Question 5

In the example at paragraphs 90 and 91, how does the asset transfer alter the risks
assumed by the two associated enterprises under the arm’s length principle?

On a combined basis, which is economic reality and not the independent treatment under the
arm’s length hypothesis, there is no altering of risk; only some increased expenses due to
some duplication of costs.

Viewing each subsidiary S1 and S2 separately, we believe that the description of the effects
on relative risk factors as explained in paragraph 91 is an excellent summary. We have
nothing further to add.
Question 6

In the example at paragraphs 90 and 91, how should risk-return trade-off implications be taken into account under the arm’s length principle?

Let’s discuss this briefly through an example.

Assume that X, resident in country A, manufactures a product in country A and sells that product around the world. Due to increased demand in Asia that cannot be met by the limited capacity of X’s manufacturing facilities in country A, X conducts significant research of possible sites for a green field manufacturing facility within Asia. After deciding on a specific site in country B, X establishes Y as a wholly owned subsidiary resident in country B to acquire the site and construct a new facility using X’s manufacturing processes and procedures that will manufacture the product using all of X’s relevant intellectual property. X will train Y’s personnel and oversee and control all aspects of Y’s manufacturing operations. Sales, whether of product manufactured by X or by Y, will be made through the same independent distributors that have previously served X. All sales as well as the network of independent distributors will continue to be controlled and managed by X personnel.

In this example, X will continue its historical control and management of its business. The addition of Y is adding to product capacity.

From a perspective of risk-return trade-off implications, X’s intellectual property is being used and X is managing and controlling virtually all elements of risk. Irrespective of how X and Y’s contractual relations are structured (whether through a license of intellectual property, a contract manufacturing service agreement, etc.), it is clear that X should receive a return that is related to the significant risks it is managing and controlling. Y, with the few risks it is responsible for, should receive a return that is relatively lower.

In this example of X and Y, the risk-return balance follows the activities of the two enterprises.

In the example of S1 and S2, there is no conformity of responsibility and contractual risk. There is a complete mismatch. Further, as explained in paragraph 92:

“The scenario set out in this example suggests that the transaction lacks the fundamental economic attributes of arrangements between unrelated parties; the arrangement does not enhance or protect the commercial or financial position of Company S1 nor of Company S2.”

The heart of this conclusion is based on this mismatch since independent parties would simply not act in this manner. As such, in response to this Question 6, “how should risk-return trade-off implications be taken into account under the arm’s length principle”, our response is that they should not be respected unless they are supported by an appropriate factual situation such as that described in the above X/Y example.

The specialist legal and business knowledge, effort, and resources required for a tax authority to analyse group members to truly understand their actual operations and how they compare to their contractual relationships means that MNEs may be comfortable that there will be few tax audits of sufficient depth to uncover situations such as described in this Question 6. Again, we suggest that our section 1 overall recommendation should be seriously pursued.

Question 7

Under the arm’s length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk?
Consistent with our response to Question 6, any transaction that shifts risk to an associated enterprise without also transferring the actual management and control of that risk should not be respected for transfer pricing purposes. Having said this, we have not responded to sub-questions 7a) and b).

**Question 8**

*Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?*

Yes, the general discussion of risk does apply to financial services activities. Considering the fact that financial industry MNEs and financial management within non-financial sector MNEs are among the most serious BEPS players with their many financial machinations and common use of tax havens, the concepts discussed in this discussion draft should apply fully to them. There should be no distinctions made.

**Part I Other Comments**

**Part I, Paragraph 82**

‘However, in exceptional circumstances the transaction as accurately delineated may be interpreted as lacking the fundamental economic attributes of arrangements between unrelated parties, with the result that the transaction is not recognised for transfer pricing purposes.’

The BEPS process generally and the Luxembourg leaks revelations in particular have shown that major tax avoidance by many if not most MNEs has been occurring through distortion of the separate entity principle. With the general need under the Guidelines for each situation to be judged on its own facts and circumstances, it is inappropriate and misleading to include in paragraph 82 language that suggests that structures ‘lacking the fundamental economic attributes of arrangements between unrelated parties’ will only be found in ‘exceptional circumstances’. As such, this language about ‘exceptional circumstances’ should be deleted in favour of more neutral language that focuses on a taxpayer’s actual conduct. We suggest that this sentence be amended to read as follows:

Where it is found that a transaction as accurately delineated may be interpreted as lacking the fundamental economic attributes of arrangements between unrelated parties, then that transaction will not be recognised for transfer pricing purposes.

**PART II POTENTIAL SPECIAL MEASURES**

**Part II, Paragraph 6**

‘It should also not be assumed that, if special measures are introduced that go beyond the arm’s length principle, double taxation may result. The main aim of these special measures is to create transfer pricing outcomes in line with value creation and to limit BEPS risks for governments. It is recognised that consideration needs to be given to the way in which these special measures will be part of the global transfer pricing standards and the way in which double taxation will be prevented.’

We suggest that when future discussion drafts on these options are released that the language make clear that while the intent is to avoid instances of double taxation, actual instances of double taxation will likely arise only where MNE groups have engaged in aggressive BEPS planning and structuring. Such planning and structuring will have created the mismatches of value creation and transfer pricing outcomes that these Part II options are meant to overcome.
As such, if an MNE group is subjected to some level of double taxation in the future, it will very likely be the self-created BEPS structure that is to blame. MNE groups will have to live with this risk if they persist in creating such structures.

**Option 1 – Hard-to-Value Intangibles**

We believe that Option 1 is a necessary addition to the Transfer Pricing Guidelines.

The discussion draft lists two circumstances: (i) lump sum or fixed royalty rate without any contingent payment mechanism, and (ii) no contemporaneous documentation of projections made available to tax authorities. Although this might not be the intention of Working Party 6 and the OECD Committee on Fiscal Affairs, but as presently drafted, Option 1 would only be effective in situations where both of these two circumstances exist.

Option 1 should be effective in all situations where either of these two circumstances exist since either circumstance is clear evidence of potential serious BEPS behavior. The word “and” that now connects the two circumstances must be changed to “or”. Future drafted language that would be added to the Transfer Pricing Guidelines to reflect this Option 1 must include the word “or” to make this clear.

**Part II, Option 2 – Independent Investor**

We believe that Option 2 is a necessary addition to the Transfer Pricing Guidelines.

Of the two approaches listed in Option 2, the much better approach is the first, under which the capital would be deemed to have been contributed to the company providing the more rational investment opportunity with the result that it directly owns the asset. This approach is significantly better than the second approach, which would place ownership of the asset in the parent company.

Reasons for our belief include:

- **Consistency with actual conduct of the parties.** In situations where Option 2 is relevant, the real operating company is conducting business and is managing risks concerning the investment. Treating it as the owner most closely aligns actual functions and activities concerning the asset with ownership of the asset for tax purposes.

- **Simplicity of administration.** To place the parent company in the shoes of the capital-rich, asset-owning company is merely changing the players and is not eliminating in any way the terribly subjective transfer pricing problem. Under the second approach, there is still the need to calculate a risk-adjusted rate of return on the funding that the parent company is making under the re-characterization of this second approach. Under the first approach, there is simply no transfer pricing issue since the asset is considered to be owned by the company that is developing, using, and protecting it.

- **Discouraging BEPS behaviour.** Under the first approach, no return would be attributed to either the capital-rich, asset-owning company or the parent company that orchestrated the BEPS structure. This is the best approach since multinationals will be discouraged from conducting BEPS structuring, where clearly articulated consequences show that their time and expense to create such structuring will be wasted.

**Option 3 – Thick capitalisation**

We believe that Option 3 is a necessary addition to the BEPS deliverables and should be an important component of the recommendations to be made concerning CFC rules.
We believe that Option 3 is not in any way an appropriate addition to the Transfer Pricing Guidelines, which would require a corresponding adjustment to record interest expense on the books of the capital-rich company. We believe this for the following reasons:

Where a capital-rich company is located in a low-tax or zero-tax country, the interest deduction will have little or no effect.

Where a capital-rich company is located in a country where it conducts real operations, then there will be a lowering of that country’s tax base that reflects conditions and factors occurring outside that country and over which that country’s tax authorities have generally neither knowledge nor control. Further, requiring recognition of interest expense and the attendant analysis of and agreement by the local tax authorities with the interest computation made by the tax authorities of another country is the exact opposite of simplification.

MNEs that structure thickly capitalized subsidiaries with BEPS objectives must be penalized for doing so. To grant them the benefit of an interest deduction within the capital-rich company is reducing their cost of paying increased taxes to their home country at the expense of the capital-rich company host country. MNEs will only discontinue BEPS activities if they are effectively penalized for doing so. They must pay the relevant taxes that accrue under the BEPS structures they have created. Yes, there will be some double taxation. And this is appropriate and necessary to make MNEs curtail their BEPS structuring.

Regarding the approach to determine the level of thick-capitalization, simplicity and reality strongly suggest using either the debt-equity ratio reflected on the MNE’s consolidated financial statements or whatever “best practices” approach is eventually determined under BEPS Action 4 concerning interest deductions and other financial payments. Whichever is used should be readily available and will reflect actual borrowings from unrelated lenders. Only where there are peculiar situations such as regulatory requirements or non-recourse lending covering specific assets should there be potential adjustments to this approach.

Option 4 – Minimal functional entity

We believe that Option 4 is a necessary addition to the Transfer Pricing Guidelines.

We agree that minimal functional entities should be those entities that fail to meet either the qualitative test or the quantitative test. It would not be necessary for a tax authority to demonstrate that an entity meets both tests. Further, especially given the tax authority’s limited resources and knowledge and the entity’s extensive existing knowledge of itself (as well as the knowledge of the MNE group of which the entity is a part), the burden of proof should be on the entity to establish that it does not meet either test where a tax authority has raised this issue.

Regarding options for reallocation of a minimal functional entity’s profits, we believe that the first approach using the profit split method would be best if the Transfer Pricing Guidelines, as finalized after all BEPS efforts this coming year, include clear and administrable approaches to applying the profit split method. Elsewhere, we have made comments on the profit split method discussion draft and encourage expansion of its use. Clear direction to apply the profit shift method rules in the case of any minimal functional entity would harmonize and coordinate rules.

If for any reason this profit split method approach is not recommended in a future discussion draft, then we believe the next best approach is the third bullet point under which the minimal
functional entity’s profits would be re-allocated to the one or more companies providing functional capacity.

The second bullet point under which the profits would be re-allocated to the parent (or some higher tier company) would be completely inappropriate since that would place the profits in a company other than the company or companies that in fact provide functional capacity and conduct the operations that earned the relevant profits. It would be the exact opposite of aligning taxation with value creation.

Option 5 – Ensuring appropriate taxation of excess returns

While the overall concept of Option 5 has merit, its terms as presently described are terribly counter-productive and will only encourage BEPS behavior. It is absolutely counter-productive if \( x\% \) is below the general corporate tax rate in the home country and is both the trigger for application of the CFC rule and the rate of tax to be applied under the CFC rule in the home country of the MNE on that income. Where an MNE knows that profits shifted will ultimately be taxed at this lower \( x\% \) rate instead of the higher home country corporate rate, it will be highly motivated to continue BEPS efforts.

We make the following points to transform Option 5 into an approach that will truly deal with BEPS behavior:

We accept and agree that the trigger for applying this Option 5 should be a defined average effective rate of tax. However, this average effective rate of tax (\( x\% \)) must be a percentage that is very close to the general corporate tax rate in the home country. While it would be best if \( x\% \) were equal to the general corporate tax rate in the home country, we strongly suggest that \( x\% \) be no lower than 95% of the general corporate tax rate in the home country. Any rate lower will be a strong motivation to MNEs to continue shifting profits.

Where a CFC’s average effective tax rate is below \( x\% \) so that the CFC rule applies to currently tax the profits in the home country, then the tax rate to be applied under the CFC rule must be the home country’s general corporate tax rate. If it is any lower, then there will be strong motivation to MNEs to continue shifting profits.

We recognize that there will be situations where current taxation under the CFC rule at the level of the parent may present a hardship. In such cases, it is reasonable to provide for deferred payment of the taxes due, but there must be a reasonable interest rate charged for any period of deferral.

We agree that there should be a foreign tax credit allowed for any foreign taxes paid on the profits currently subject to tax in the hands of the parent company under the CFC rule.

For both simplicity and the prevention of profit shifting, we strongly recommend that there be no inclusion in the CFC rule of an ‘excess returns’ concept. Rather, there should only be a carve-out for local income from sales or services to unrelated persons for ultimate use or consumption in the CFC’s country of tax residence.

We wholeheartedly agree with the inclusion of a secondary rule. We recommend the following approach for overall consistency with the separate entity concept, good transfer pricing principles, and simplicity. The CFC and all relevant associated enterprises should apply the profit split method to apportion the CFC and the other enterprises’ profits amongst themselves. If the CFC has legitimate operations, then it will be treated as earning an appropriate profit. If its operations are very limited, then most or all of its profits will be considered the profits of the associated enterprises.
Elsewhere, we have made comments on the profit split method discussion draft and encourage expansion of its use. Clear direction to apply the profit shift method rules in this secondary rule procedure will harmonize and coordinate rules.

**Part II, Other Comments Concerning Options**

The following additional comments are made to respond to certain of the questions included in the Discussion Draft on pages 39 and 40 in the box labelled “Framework for questions on all options”.

**Question 7**

*In what order should the measures apply? Does the measure come into consideration following the application of normal transfer pricing rules, or should it be applied instead of transfer pricing rules?*

**Overall Comment**

Local country rules and judicial concepts that allow legal entities and transactions to be disregarded or re-characterized to reflect the true nature of enterprises and their activities must be applied first. Then, transfer pricing, CFC, and other relevant rules would be applied by each relevant local country. Where two or more countries recognize or disregard enterprises and their transactions in differing manners, the MAP process would be used to avoid double taxation where appropriate.

**Options 1 – 4**

No comments

**Option 5**

Under normal circumstances, the home country of the MNE would apply transfer pricing rules first in determining the profits that are earned by the CFC. Then it would apply its CFC rules. However, in this situation where the CFC is seen to be earning amounts of profits that are higher than its activities and assets merit, it would be appropriate to simply apply the CFC rules if application of the transfer pricing rules would reduce the amount of profits subject to the CFC rule. In this way, MNEs would be effectively penalized for any aggressive BEPS planning and structuring.

**Question 8**

*Should mechanisms be available for eliminating double taxation, even if the rules are considered to be anti-abuse measures, and how should any such mechanisms be framed?*

**Overall Comment**

The answer is “No”. There should be no automatically operating mechanisms for eliminating double taxation that has been caused by the positive BEPS planning and structuring conducted by MNEs. If there are any such mechanisms to eliminate double taxation that cause MNEs to be no worse off than if they’d done no such planning in the first place, they will have full motivation to continue BEPS planning and structuring. MNE groups will only act conservatively if they might end up worse off than they would be had they conducted no BEPS planning and structuring. Only in this way will there be a real behavioural change that will curtail BEPS efforts.

We can imagine that there may be cases where an MNE’s legitimate non-tax motivated structuring is caught by certain BEPS measures. If local countries wish to provide on an exception basis discretionary relief to such cases though the MAP process, then that would be
appropriate. However, there must be no automatically operating mechanisms; that will only encourage BEPS behaviour to continue.
Dear Andrew,

BIAC thanks the OECD for the opportunity to provide comments on its three Discussion Drafts covering elements of Actions 8, 9 and 10 of the Base Erosion and Profit Shifting (BEPS) Action Plan issued on 16 & 18 December 2014 (the Discussion Drafts). We acknowledge and thank you for the huge amount of effort that you and others have put into these drafts.

There is no doubt that transfer pricing issues, along with deductible payments, lie at the heart of the BEPS project. Governments have expressed concerns about aggressive structures in certain contexts, lack of clear (or any) guidance in others, and the perceived inability of the fact-driven arm’s length standard to deal with new situations in still others. BIAC agrees that all of these areas should be examined, and that the legitimate concerns of governments fully and swiftly addressed. However, BIAC also believes that the arm’s length standard, properly applied by both taxpayers and governments, still offers the best prospect of classifying transactions according to “real-world” economics, and equitably and consensually dividing income between countries based on economic activity. If this is not clearly articulated, however, then we will see a further acceleration in a worrying trend already apparent in the transfer pricing audit practices of several countries, where a broad interpretation of “BEPS principles” is used to justify new unilateral theories, and the automatic application of non-arm’s length approaches in routine situations.

So, elements of the proposed guidance in currently unclear areas such as risk or commodity transactions are greatly to be welcomed – but such guidance should build upon established concepts rather than upon new ones (such as, for example, “moral hazard”). Likewise, profit splits may well be appropriate in certain difficult cases – but the default position, nevertheless, should be application of the arm’s length standard, with profit splits only being applied where the default
position cannot be. Recharacterisation, or “special measures”, which recast a contract or other legal arrangements from the form agreed by the parties into a new and different form, may be justified in egregious cases – but only when other alternatives, most particularly, the proper application of intercompany pricing principles, have been tried and failed. While it may sometimes be more time-consuming to run through a full functional analysis, than to move swiftly to a recharacterisation, such a functional analysis (the elements of which are broadly agreed and widely understood) not only provides more commercial certainty for taxpayers, but also benefits governments because there will be fewer instances of double taxation as different countries seek to apply different rules with no commonly-agreed standards.

Finally, and as noted in my comments on Action 14, particularly if dispute resolution is not improved, then business may return to a more adversarial relationship with tax authorities and, especially in the complex area of Transfer Pricing, seek new ways to mitigate double taxation in the face of risk from ad hoc recharacterisations, and non-arm’s length practices. A return to this type of cat and mouse game would be to neither the advantage of governments nor the vast majority of responsible, unaggressive taxpayers.

In each of our three sets of comments, we give much more detail on where we think the new proposals will eliminate BEPS-related issues, and/or provide new and helpful guidance. Likewise, in our comments we also present what we hope are constructive alternatives, where we disagree with proposals made in the three Discussion Drafts. To reiterate, however, while we acknowledge weaknesses and gaps in the current rules, and are supportive of moves to rectify both, we also strongly advocate that the arm’s length standard, and the legal form adopted by taxpayers, remain the starting point – if not always the ending point – for dealing with the matters raised in Actions 8-10.

We very much hope that you find our comments useful, and we look forward to working with you on these important issues over the next several months.

Sincerely,

Will Morris
Chair
BIAC Tax Committee
Contents

Executive summary ................................................................................................................................. 4
General comments ................................................................................................................................. 5
Specific Comments ................................................................................................................................. 7
  Identifying the commercial or financial relations ............................................................................. 7
  Identifying risks in commercial or financial relations ....................................................................... 10
  Interpretation and Non-recognition .................................................................................................. 17
  Moral Hazard .................................................................................................................................... 18
  Risk – Return ..................................................................................................................................... 19
Special Measures ...................................................................................................................................... 20
  Hard-to-value intangibles (Option 1) ................................................................................................ 22
  Inappropriate returns for providing capital (Options 2 and 3) ......................................................... 22
  Minimal functional entity (MFE) (Option 4) ...................................................................................... 23
  Ensuring appropriate taxation of excess returns (Option 5) ............................................................ 24
Sector Specific Comments .................................................................................................................... 24
  Insurance Sector ............................................................................................................................... 24
Executive summary

1. Transfer Pricing must be grounded in business reality and we welcome the Discussion Draft’s focus on actual conduct and expanded consideration of risk. Businesses operate in today’s fast-moving global markets and generally do not measure or manage themselves on a territorial basis. It is vital, therefore, that any Transfer Pricing requirements are practical, and capable of implementation and interpretation without creating a significant additional compliance burden for either MNEs or the tax administrations who audit them. We are concerned that the Discussion Draft attempts to insert highly theoretical concepts such ‘moral hazard’ and ‘fundamental economic attributes’ into the Transfer Pricing Guidelines1 (the “Guidelines”) and in doing so, shifts the balance away from practical reality and towards economic theory.

2. We question the practicality of requiring documentation to consider, for every transaction, all alternative options realistically available at the time the transaction is entered into. Not only does this impose a significant compliance burden - given that information available at a particular point in time is often incomplete or incorrect - it also encourages tax administrations to look at transactions with hindsight, as it is not possible to look back and know only what was known at the time of the transaction. In a similar vein the level of analysis required for consideration of risk appears to be very granular and it is questionable whether such a detailed analysis is feasible for MNEs with thousands of entities and transactions.

3. Certainty is a key concern for MNEs in their relationships with tax administrations and their reporting of financial results to the market and investors. Any change that increases uncertainty, for example the possibility that recharacterisation might be applied more frequently (as the Discussion Draft appears to lower the barrier to non-recognition), should be made with the utmost care and an understanding of the consequences, both for the counterparty tax administration and the taxpayer. We feel that the proposed Guidelines do not contain sufficient safeguards to prevent compliant taxpayers being erroneously swept into recharacterisation. This will undoubtedly give rise to increased cross-border tax disputes, with their consequent drain on resources for both tax administrations and taxpayers, and potentially double taxation. Wherever possible, we believe that pricing adjustments should be used before non recognition is contemplated.

4. We very much welcome the expanded consideration of risk and risk allocation, although we would note that this needs to be reviewed for consistency with Chapter IX of the Guidelines. We understand the theoretical assumption that third parties may be allocated a greater share of risks over which they have control. In practice, however, risk allocation among third parties is more complex, and can be driven by factors which do not align with this principle. Further consideration of this section is required, in particular the assumptions that certain risks are not transferred at arm’s length and that risks cannot be transferred within an MNE group.

5. We find it difficult to understand the need for special measures options 1 – 5, given the existence of a comparability analysis, the availability of group-wide information that will be delivered via BEPS Action 13, and the possibility of applying non-recognition. We believe these tools should be sufficient to deal with all matters, using the arm’s length principle. We

---

1 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD July 2010
consider the arm’s length principle remains the best available and most widely accepted basis for Transfer Pricing methodologies, a view we understand is shared by the OECD and the countries participating in the BEPS process. We are concerned that special measures represent a move away from this consensus view towards individual country interpretations of locally implemented rules, resulting in significantly more tax disputes and double taxation.

6. A move away from the arm’s length principle can also be seen in the suggestion that a comparison of pre- and post-tax results is a factor to be considered in recharacterisation. We believe this is not relevant for the pricing of a transaction in accordance with the Guidelines.

7. The Discussion Draft rightly focuses on the contribution of people functions and the allocation of risk. However, it is largely silent on the role of capital. Capital is a requirement for all businesses, not only to allow business to invest and grow, but also to absorb losses in difficult times. We feel, therefore, that a greater acknowledgement of the role of capital is needed for all MNEs, but in particular for MNEs in regulated sectors where capital is an essential component of their business.

General comments

8. BIAC welcomes the opportunity to comment on the OECD’s Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures) (the “Discussion Draft”). We support the Discussion Draft’s recognition that the delineation of Transfer Pricing transactions must follow business realities, encompassing the actual conduct of parties and the actual allocation of risk, and that contractual terms should reflect this reality. We also broadly support the methodology set out in Section D1 of the Discussion Draft as it reflects best practice for most MNEs when they define and implement their Transfer Pricing policies.

9. We support the ambition behind the substantially new Section D2 of the Discussion Draft, to augment the existing guidance on risk given in Chapter I of the Guidelines. That being said, we believe it is important to provide context to the Discussion Draft, to establish clearly what Transfer Pricing seeks to achieve in general terms. The Guidelines are a tool used by taxpayers and governments to translate highly-complex economic theory, through the use of the Arm’s Length Principle, into a highly practical framework. In this regard, there is a fine balance to be struck between that theory, and practical realities. The Arm’s Length Principle represents the best tool that we currently have for balancing those considerations. We do agree that the Guidelines must be economically correct in general terms, but they must also be capable of consistent application, and yield reasonably predictable results. We believe that the Discussion Draft has shifted this important balance towards economic theory, and away from practical reality. This may be driven by an expectation that Actions 8-10 are capable of tackling many issues that are also being addressed through other BEPS Actions – we believe that the scope of this Transfer Pricing work should be limited to proposals that are appropriate under the Arm’s Length Principle, otherwise the Guidelines will become overburdened and impossible to apply.

10. Our concerns about the theoretical nature of the Discussion Draft extend to the analysis of “group value” and “risk allocation” – these concepts are highly complex, and very difficult to translate practically. This is illustrated through the lack of examples of their application. We also believe that the theoretical focus has resulted in an understatement of the returns that
should be due to financial investment, focusing too heavily on the expectation that control or management of risk must accompany the financial burden of a risk to justify returns.

11. In extending the Guidelines, care is needed to ensure that compliant taxpayers are not inadvertently brought within the scope of onerous rules. In that context, we would note that the examples given in the Discussion Draft sometimes cover standard scenarios and do not always represent situations where contractual terms are ambiguous, incomplete or incorrect. Retaining the current examples may place too much focus on genuine commercial transactions that are already in compliance with the Guidelines. There is a risk that such examples would give rise to a broad interpretation, placing an additional burden on compliant taxpayers. We would therefore propose using alternative examples for greater clarity and would also welcome examples that are more clearly aimed at situations that are targeted by the BEPS project. At the inception of the BEPS project, governments appeared to be focused on such specific examples, which should be included in the Discussion Draft to reduce ambiguity, and to ensure that genuine transactions are not unnecessarily caught up in overly-burdensome requirements.

12. We would be grateful if the revised Guidelines could contain a clear statement that they apply with effect from the date they are issued, and not retrospectively. This clarity around application would reduce uncertainty for MNEs already engaged in tax audits, or with significant numbers of past open years.

13. We appreciate that the objective of the Discussion Draft is to encourage a review of actual conduct and risk allocation, and there is no policy intention for this work to result in an increase in the frequency of recharacterisation. However, we are concerned that the new standards set out in the Discussion Draft, such as the proposed principles for identifying risks under D2, are onerous and even compliant taxpayers making their best efforts could fail, or be seen to fail, to comply with these new standards, and hence, will face an increased risk of re-characterisation. To assist tax administrations, we would be grateful if there was a more forceful statement of how to review intercompany transactions, so that it can mirror the work that MNEs carry out when analysing such transactions.

The order should be as follows:

- The primary analysis is to identify/delineate the transaction
- The starting point for this is the contract, or the functional analysis performed by the taxpayer if there is no contract
  - only after this review has been completed, and only if necessary, is it then appropriate to ask if the transaction makes economic sense: if the transaction makes economic sense but is not properly priced based on the arm’s length principle, the right price shall be assessed.
  - ii. if the transaction does not make economic sense, recharacterisation should occur in exceptional circumstances.
Specific Comments

Identifying the commercial or financial relations

14. We welcome the statement in Paragraph 3 that where a contract exists, it should be the starting point for delineating a transaction, and that actual conduct should be reviewed in the context of this written agreement. Taxpayers require certainty, and should be able to rely on legal agreements they have entered into with related parties as well as third parties. Only where contractual terms are absent or ambiguous in the context of actual conduct, should they be clarified or supplemented by the tax administration.

15. At arm’s length, it is common for an agreement to be varied slightly in practice without recourse to a full re-negotiation or amendment of the existing contract; this does not mean that the entire contract is invalid. Tax administrations should accept that this may also happen between related parties, and, where that is the case, significant supplementation or clarification should not be required. An acknowledgement that slight variations can exist without the need for significant additional review would be helpful. For example, a group company may enter into a multi-year agreement with a group procurement centre, where prices would be fixed for the duration of the contract. However, if the costs borne by the procurement centre significantly deviate because of fluctuations in the underlying commodities prices, or, conversely, if prices to be paid by the group company significantly differ from market prices because of a drop in commodities prices, the parties may agree to change the pricing mechanism of the contract without entering into full re-negotiation of the contract. This decision may be impacted by the magnitude of the financial impact for the parties. This often happens with third party suppliers and should not be regarded as being non-arm’s length behaviour. Another example would be where a Research and Development (“R&D”) centre has entered into a contract with group companies in order to undertake R&D activities, and has also agreed to handle the registration of the licenses deriving from the R&D activities, even though this activity was not initially included in the contract. Such a slight variation of the scope of R&D services, would probably not be subject to an amendment to the contract in an unrelated party context, even if the registration of the license might also be regarded as a key element of the valuation of the licenses.

16. We have commented in Paragraphs 18 to 23 below, on the examples given in Section D1 of the Discussion Draft. Whilst the inclusion of carefully drafted examples may assist MNEs in formulating and implementing Transfer Pricing policies, and help tax administrations in auditing those policies, we feel that the examples proposed are overly simplified and reflect common commercial situations where the Transfer Pricing is relatively straightforward. We feel that alternative examples would more clearly illustrate the need to supplement or clarify contractual terms and would avoid compliant taxpayers being subject to additional and unnecessary scrutiny.

17. The example given in Paragraph 4, which aims to illustrate the need to supplement contractual terms, describes a common scenario in which a distributor not only distributes products, but also advertises and markets those products. The example notes that the contract is silent on remuneration specifically for marketing activities and that further detailed analysis is required. Selecting such a common transaction for use as an example raises the question of granularity: remuneration for the marketing activities is very likely already built into the reward for distribution, as in many franchisor/franchisee relationships and thus the independent entities
or transactions identified in the comparability analysis are often likely to already exhibit such attributes. A further granular analysis would potentially be double-counting the reward. How far is an MNE required to go in analysing relatively straightforward transactions, of which it may have thousands?

18. An alternative example for Paragraph 4 could be: Company P is the parent company of an MNE group situated in country P. Company S, situated in Country S, is a wholly owned subsidiary of Company P and acts as an agent for Company P’s branded products. Company’s P branded products are new to the Country S market. The contract between Company P and Company S is an agency contract, i.e. Company S sells P products on behalf and in the name of Company P. The contract is silent about any marketing and advertising activities in Country S that the parties should perform. In practice, Company S had to launch an intensive media campaign in Country S in order to develop brand awareness. This campaign represents a significant investment for Company S. Based on these specific factual circumstances, and on a review of the functional analysis performed by the group, it may be concluded that the contract does not reflect the full extent of the commercial or the financial relationships between the parties, and that the analysis should not be limited by the terms of the contract. The additional step to take on would be to analyse whether or not the functional analysis needs to be revised, and the transaction repriced (better delineation of the transaction), or if the transaction does not make sense commercially, and if the agency relationship has to be recharacterised into a distribution agreement. It is important that the first step is undertaken (delineation) before the potential recharacterisation analysis takes place.

19. We agree with most of the content of Paragraph 5, but believe that the second and third sentences may bring some confusion to the reasoning. We also suggest adding the word “substantially” in the 4th sentence, which would read as follows: “it is therefore particularly important in considering the commercial or financial relations between associated enterprises to examine whether the arrangements reflected in the actual conduct of the parties substantially confirm to the terms of any written contracts...”.

20. Paragraph 6 includes an example illustrating the need to supplant the terms of a contract with the actual conduct of the parties. The example concerns a licence arrangement in which the licensee is deemed not, in fact, to be a licensee, but rather a provider of services. This is based on the premise that the licensee is not capable of providing services to third parties without additional support, and is not developing its own capability. In reality, it is common for licence arrangements to include technical support or helpdesk services, and many licensees do not develop their own capabilities. The licence is a right to use, copy or distribute intellectual property, not the right to be involved in maintenance or development. Retaining this example risks bringing into the scope of inquiry a significant number of genuine licence arrangements, and may trigger some significant recharacterisations of standard contracts by tax administrations. We believe the example in Paragraph 6 is relevant for delineation and pricing, rather than the recharacterisation of a contract into another category of contract.

21. Whilst we generally agree with Paragraph 7, it may require some clarification with regard to the reference to the booking of some elements into the accounting systems. It should be noted that synergies, for example, do not translate into an accounting entry. This should not be the starting point for believing that the company has not recognized a transfer of value pertaining to a transaction. Synergies are a good example of why group companies exist and
cannot be perfectly compared to SMEs, or non-integrated businesses. For example, a manufacturer within a group can benefit from synergies - e.g. it may benefit from additional volumes when it is in an undercapacity situation to better absorb its fixed costs. Such synergies are often not reflected in the contracts, they do not directly appear in the accounting systems, and very often are not an element of a functional analysis. If businesses need to take into account elements deriving from being part of a group in delineating a transaction, it will entail a significant additional compliance burden, which, more importantly, would be very difficult to incorporate into a Transfer Pricing policy and be appropriately priced.

22. The example in Paragraph 8 aims to illustrate a situation where the taxpayer has not identified a transaction. In the context of this example we do not believe a transaction has occurred for Transfer Pricing purposes. Subsidiaries receive services from a third party for which they appear not to be charged, either via reimbursement to or a service charge from the entity paying for the services. The example could be expanded to acknowledge the fact that there may be no direct charge for the services, but the service could be taken into account in the pricing of another transaction between the parties. Given budgetary constraints and performance measures, it is rare for services to be provided for free within the context of an MNE.

23. We are concerned about the potential scope of work proposed by Paragraph 12, which notes that when evaluating potential transactions, independent enterprises compare the transaction in question to ‘the other options realistically available to them’ and will only enter the transaction if there is no better opportunity that meets their commercial objectives. This concept is carried further in Paragraph 89, which states that an entity would only enter into a transaction if there was ‘a reasonable expectation of enhancing or protecting its commercial or financial position on a risk adjusted basis’. Whilst this is true in theory, in practice, it is rare that the alternative options are presented so clearly at the time: decisions are made under pressure of time and with incomplete or sometimes inaccurate information. It is not possible to contemporaneously document all options available at a given point in time. Therefore, to try and do this in hindsight, even days or weeks after the transaction, let alone in the context of a tax audit which might be years later, is simply not possible. The options that were realistically available at the time and the options that appear to be available with the benefit of hindsight are very different. There is a risk here that the tax authority deems a result that could not have been envisaged at the time of a transaction due to the different availability of information.

24. A further concern around documenting options to satisfy Paragraphs 12 and 89 is the compliance burden this would create. In addition to the options considered, Paragraph 89 refers to decisions not to undertake a particular transaction. If the documentation requirements are to cover: the transaction undertaken, the alternative options considered and the option not to undertake the transaction, then the burden of compliance increases significantly. This would further be multiplied by the actual number of transactions followed up, plus any that were considered but not implemented. The task of identifying such a broad scope of transactions, let alone documenting them, would require significant additional resource. It is not clear what benefit would be achieved in return for such a significant cost. Some guidance around materiality would be welcome in order to ensure the additional compliance obligation is proportionate and not unduly burdensome.
25. Paragraph 16 of the Discussion Draft states that ‘it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the parties with the rest of the group, and the contribution that the parties make to that value creation.’ We are very concerned about how this guidance could be interpreted, and that it could impose a disproportionate burden on taxpayers to not only document facts and circumstances, but to also interpret the many hundreds or thousands of ways that those facts and circumstances may directly or indirectly impact the creation of value elsewhere in the value chain. We believe this would be an impossible task for almost all taxpayers. The lack of relevant examples in the Discussion Draft makes it difficult to interpret the expectation behind this proposal.

26. The example given in Paragraph 18 is not clear to us. It seems to imply, due to diversification within a group, that a market price cannot be applicable for related party transactions (although presumably it would be the price charged by a third party). Such an approach appears to suggest that a market price ought always to be adjusted downward to apply to related party transactions to take into account the impact of the group. As we have suggested elsewhere in this paper, we believe such an approach would be contrary to the objective of the arm’s length principle, and almost impossible to apply in a practical and predictable way. We would be grateful for further clarity around this example.

27. Paragraphs 21 and 85 – 87 refer to MNEs’ ability to fragment their activities across multiple entities ‘secure in the knowledge that the fragmented activities are under common control’. At the ultimate parent level, an MNE acts in the common interest of the group: its aim is to make a return for its shareholders. However, at a regional, divisional or legal entity level there are often competing interests and obligations within a group. Furthermore, under the corporate law of most jurisdictions, a Board of Directors has a duty to act in the best interests of their individual entity, not the group. Therefore, whilst the Directors may act in the group interest, they cannot legally approve an operation or action that is against the interest of the particular entity. In regulated sectors, such as Financial Services, local country regulators take a standalone view of business and require entities to transact with associated entities at arm’s length and not to focus on group interests.

Identifying risks in commercial or financial relations

28. BIAC welcomes the objective of increasing the clarity of practical guidance around risk, and the extended consideration of risk in Section D2, as this work has the potential to reduce the number and length of tax disputes. However, as the Discussion Draft notes in Paragraph 38, risks can give rise to difficulties in a Transfer Pricing analysis. Whilst some risks are clearly known and can be quantified on a probability basis, other risks may be known, but unquantifiable, and certain risks may be neither identifiable nor measurable until after they have materialised. It is equally often very hard to determine reliably, exactly how unrelated parties approach and accept risk. Although we welcome the ambition of outlining a risk framework in Paragraphs 40 and 42 as a tool to assist tax administrations in understanding and identifying risk, we are concerned that the standards set out in this section may, in practice, be very difficult to comply with as the analysis operates at a micro-level, and requires a granular and onerous level of compliance. This granular approach, rather than reducing the potential for disputes, is likely to increase the risk of controversy and double taxation as tax
administrations are encouraged to inquire into a level of detail which is very hard or impossible to comply with in practice.

29. In general, we agree with the theoretical assumption in Paragraph 38 that it generally makes sense for third parties to be allocated a greater share of risks over which they have relatively more control. In practice, however, risk allocation among third parties is far more complex, and can be driven by a large number of factors which do not align with this general principle. The perceived profit potential in a transaction, the perceived benefit for one of the parties, or the valuation of a certain risk, frequently does result in risk assumption which deviates from this general principle. As an example, at arm’s length, the assumption of credit risk may be accepted by an exporting market company even though the detailed day to day control of that risk lies closer to the importing dealer company on the basis that the market company considers the risk to be very low, and the dealer company is not willing to take on the sales activity carrying that risk. Therefore, the guidelines should be clarified to say that the theoretical principle suggested in this paragraph (and elsewhere) can only be a starting point in the analysis.

30. We believe the example in paragraph 41 may trigger some misunderstanding and misinterpretation in certain jurisdictions, and would suggest the following amendments in order to make the point.

“The significance of the risk depends on the context: a different flavour of baked beans may not be the company’s sole product, the costs of developing, introducing, and marketing the product may have been marginal, the success or failure of the product may not create significant reputational risks so long as business management protocols are followed, and decision-making may have been effected by delegation to local or regional management who can provide knowledge of local tastes. However, in certain circumstances, such a new product, because of certain characteristics (less salt/less fat) can give the company a competitive advantage or /and feed most of the growth for future years. Risks may therefore vary depending on the factual circumstances surrounding the launch of the product. A basic technology may or may not have the same feature than a ground breaking technology.”

31. We are concerned by the examples suggested in Paragraphs 44 and 45 regarding the allocation of risk. Although the reason for selecting a certain transactional currency between independent parties is typically to establish the agreed allocation of F/X-risks, this often does not apply between related parties. Within a group, the application of transactional currency may be driven by several other factors, such as lack of system support, global hedging optimization, human errors in the transactional implementation etc. Furthermore, also between independent parties, local F/X-regulations may make it impossible to select the trading currency in a way which aligns the “conduct” with the desired risk allocation as established in the contractual terms. Therefore, the conclusion that a deviation between the contractual agreement and the functional currency should be viewed as an example where the contractual terms should be ignored based on the conduct of the parties is not correct.

32. The same holds true for the example in Paragraph 45 regarding inventory write downs. Within a group, the fact that a certain legal entity under relevant accounting rules has made a risk
related write down has very little or nothing to do with how – in this case an inventory risk –
would be allocated between independent persons. Accounting standards typically do not
consider allocation of control of risks, nor any of the other standards otherwise suggested as
important for the allocation of risks for Transfer Pricing purposes. This reference should
therefore be deleted. If not, there is a considerable risk that local tax authorities will question
any sound arm’s length risk allocation properly documented in contracts and Transfer Pricing
documentation based on the argument that it does not follow the conduct as indicated by the
accounting entries.

33. This detailed level is illustrated in Paragraphs 46 and 47 which note that assumption of risk is
not always limited to the party in which the outcome of the risk materialises. In addition
Paragraph 49 notes that risk outcomes can affect many group companies. Similarly, Paragraph
56 notes that multiple functions (and entities) contribute to risk management. Whilst each of
these statements is true, the implication is that multiple entities could assume risk or be
involved in risk management in respect of one single transaction. In practice, it is not feasible
to analyse every transaction and allocate reward for risk down to this level of detail.

34. Paragraph 49 questions the assertion that a party performing commercial activities could be
insulated from all commercial risk. This appears to be targeted at certain types of distributors
who are rewarded on a risk-free basis. The acceptance, to date, of this type of reward for
limited risk entities by the majority of tax administrations around the world indicates this is a
concept that is widely recognised and approved (provided that it is aligned with the substance
required to assume these risks as outlined in Chapter IX of the Guidelines). It should be
considered that one of the key reasons for implementing centralised risk models is the
difficulty in identifying and valuing risks in global value chains, and the acceptance of these
models has significantly reduced the compliance burden for taxpayers and freed up resources
for tax administrations to examine higher risk transactions. Including this wording within the
Guidelines could change the existing practice, and lead to extended investigations that take up
resource with little additional resulting revenues, especially when considering the reciprocal
impact of direct and compensating adjustments. Although blanket statements about risk
allocation may warrant closer scrutiny, we think that the Guidelines should clearly indicate
that such risk allocations shall be acceptable as long as they are appropriately aligned
with the control and capabilities to assume the risks.

35. We are concerned about some of the drafting around risk management in section D.2.5, and in
particular Paragraph 55. As we see it, the question of risk management is instrumental to the
analysis of risk allocation for Transfer Pricing purposes. Paragraph 55 suggests that risk
management requires the capability to make decisions to take on or decline, respond to and
mitigate risks “together with the actual performance of that decision making function”. Within
a group, risk related decisions are taken every day at every level of the organization, from
strategic decisions (about investments, budgets, corporate control functions, escalation
models, customer funding strategies etc.) at central level, to local day-to-day decisions about
individual customers, product quality improvements, warranty handling, workplace safety etc.)
- typically based on the central strategic decisions as set in guidelines and instructions. Apart
from the onerous and often impossible task of identifying and valuing risk at the level of detail
suggested in this section, without further guidance on what “actual performance of risk
making decisions” means in this respect, we see a considerable risk of increased disputes
among tax authorities about the proper allocation of risks for Transfer Pricing purposes (in
particular in cases where substantial risks have materialized). In addition, we see considerable risk that fully commercial and legitimate Transfer Pricing models with centralization of risk and IP, which have been built up and accepted by a large majority of tax authorities around the world, will be very difficult to sustain, and may be caught up inadvertently by the wide drafting of the revised Guidelines. On this basis, we believe that the Guidelines should further clarify what types of decision making functions are required to be able to manage, control and thereby assume risks from a Transfer Pricing perspective. Indeed, we fully recognize the need to prevent unacceptable allocations of risk (and IP) to entities or jurisdictions without proper capacity, authority or substance to assume those risks. However, without further clarity in this respect, we believe that the suggested new guidelines would significantly drive compliance, uncertainty and disputes.

36. As noted in Paragraph 36 above, it would be helpful if Paragraph 55 could distinguish more clearly what is meant by risk management and control of risk, and why these two concepts, which in practice seem very similar, should be treated differently. If risk management is to be regarded as a function that can be carried out at all levels, and therefore perhaps worthy – in the appropriate circumstances - of a more routine reward, and control is to be regarded as a ‘higher’ function that is more strategic in nature, it would be very helpful for Paragraph 55 to say so more clearly. This would facilitate the framework for analysing assumption of risk and allocation of reward.

37. We would also appreciate clarification in Paragraph 56 regarding the level to which the Transfer Pricing analysis should go. As written, it appears that each transaction must be analysed to line management level in every entity, which is not feasible. As the Discussion Draft notes, risk management is carried out at several levels within an organisation. We agree with this statement, but would point out that not all levels of risk management make the same contribution towards controlling risk and different organisations may have very different risk management structures. We feel the analysis in Section D2 does not sufficiently distinguish between these different levels of contribution to either management or control of risk, and that this will lead each tax administration to apply its own interpretation as to how control of risk and allocation of reward should be attributed. Clearer guidance is therefore required to avoid multiple interpretations of the same fact pattern.

38. Whilst we agree that risk management is a fundamental element of a functional analysis, it should be noted that the usual way to undertake a risk analysis in a Transfer Pricing study is through a global analysis of the main risks pertaining to the business, rather than a risk analysis transaction by transaction. We would be grateful for confirmation that this is not the approach proposed by the Discussion Draft. If we are required to include a detailed analysis of all the risks pertaining to each intercompany transaction, the Transfer Pricing Documentation would certainly be unmanageable. We believe that Paragraph 56 may lead to such a conclusion. It is possible that paragraph 56 (“line management in business segments, operational entities, (...) may (...) put in place appropriate controls and processes to address risk and influence the risk outcome arising from day to day operations”) could be interpreted by the tax authorities as requesting a management risk analysis based on the Group’s Chart of Authorities, which would clearly not be appropriate, nor manageable.

39. Paragraph 58 might be understood as requiring an adjustment to Transfer Pricing from a risk perspective when budgets are used versus actuals. We would welcome some clarification in
this respect. If the Transfer Pricing policy is predicated on the use of budget costs, for example, there is no need for an adjustment in view of actuals, even if they differ significantly from the budgeted amounts, as variances between budget and actuals will be dealt with elsewhere in the Transfer Pricing policy, unless that policy explicitly provides for actual adjustments. We would request that this clarification is included within Paragraph 58, otherwise, it appears to suggest that all budget to actual variances could be open to question.

40. Paragraph 78 also carries implications for budgeted or ex-ante outcomes versus the actual or ex-post result. Consideration is not given to the circumstances in which it might be appropriate to set ex-ante prices and leave them unchanged, irrespective of the outcome. In certain sectors (e.g. insurance) the estimation of the possible outcome is a key part of the pricing mechanism, and it is not appropriate for prices to be adjusted ex-post. It would be helpful if Paragraph 78 could include a statement confirming that in the right circumstances, ex-ante pricing is acceptable. As the wording stands, it seems to imply that an adjustment to ex-ante prices can be considered in all cases.

41. As stated for Paragraph 41, there must be some room for interpretation in the example of Paragraph 60, which does not always reflect “real life” business situations. The example assumes that product recall risk is always on the manufacturer’s side as the risk is managed and controlled by the manufacturer, and that accordingly, the manufacturer should attract the outcome of upside and downside risk instead of the distributor, as opposed to what is stated in the contract. This is an example where recharacterisation, in view of the actual conduct of the parties, may be very confusing. While the analysis might be true if the product recall clearly comes from a mistake at manufacturing level, there are many more examples where the source of the issue is not identified and a third party distributor would not, in such a case, be able to allocate the costs and financial consequences of the recall to the manufacturer. If we take for example the well-known case of the Perrier product recall in the US, where it is still uncertain that the safety allegations on the presence of benzene in some bottles were true, it would not be abnormal for a future Perrier distributor to ask for a higher margin in the contract as a high reputational and market risk may lie with the distribution of the product.

42. Paragraph 63, which suggests that risks must be analysed with specificity (in conjunction with the following paragraphs) raises a general concern about the practicality of what is being proposed. We believe that the level of detail in which risks are supposed to be identified, analysed and valued under the proposals are not achievable. Although a full functional and comparability analysis to assess the contributions by all of the associated parties to which risk relates (as required in Paragraph 65) may be valuable in theory, the tools to perform such an in-depth analysis are typically not available. Comparable data is generally not available at this level of detail, and hence, the required level of risk analysis will often not be possible in practice. We believe that even compliance focused taxpayers will most likely fail, even with their best efforts, to live up to the new standards.

43. Paragraph 64 considers the position of independent cash investors in a business and states that they will not invest unless they are given some form of security. It is common for investors to invest in high-risk enterprises without any form of security, in the expectation of high rewards (but also recognising the potential for substantial downside). The investor may seek to diversify their risk by making additional investments in other areas, but they do not directly or indirectly control or manage the business risks within the investment itself. Their
sole function is to provide capital and, if the business is successful, they will receive a significant reward in return for the provision of capital alone. Whilst the Discussion Draft provides comprehensive reviews of people, functionality and risk, it is silent on the contribution to economic value made by capital. We have provided additional information on the impact for regulated sectors in a subsequent section (see paragraphs 97 to 118). We would be grateful for additional guidance concerning the role of capital.

44. Capital is a requirement for all businesses. This is particularly so in the regulated financial services sector. Regulators require financial services firms to hold significant amounts of capital in a prescribed form; without such capital firms cannot do business. These regulatory capital requirements come from the need to protect customers, for example so that banks can repay client funds and insurance firms are able to pay out claims to policyholders. If a regulated entity does not hold sufficient capital, its licence to do business will be withdrawn. As well as regulatory obligations, rating agencies impose their own, additional, capital requirements in order for an entity to attain or maintain a specific credit rating. The particular level of credit rating is key as, the higher the credit rating, the more it opens access to a wider range of possible markets and customers. Capital, therefore, plays a vital role in the financial services sector and its contribution should be recognised.

45. A further example of the importance of capital can be seen in the mining sector, where billions of dollars are invested into exploration activities. These activities are spread across a diverse range of commodities, geographically challenging and diverse operating environments. Therefore the risk associated with exploration capital is significant. In the mining sector, the probability of discovering a World Class greenfield deposit\(^2\) is in the order of 0.07%\(^1\)1 (1 in c.1,500)\(^3\).

The evolution of a project from initial testing to commissioning can take 10 to 20 years, involving a series of stages to reach investment approval and implementation: area selection, target identification, testing, resource delineation, resource evaluation, and detailed evaluation. The number of opportunities that progress successfully from one stage to the next is low: of the many ideas and targets pursued, only a small number will make it through to a discovery. Whilst the risk associated with exploration is significant, the potential rewards are high, although the timing can be in excess of 40 years. This ensures that MNEs operating in the mining sector continue to put significant capital at risk in their exploration activities.

Typically, the parent company of a MNE operating in the mining sector is the provider of capital to either a central exploration company or individual exploration entities in a particular country. Management of risks, functions and assets (such as exploration licensees) is typically the responsibility of the exploration entity, which takes on an entrepreneurial exploration role. The parent company’s responsibilities and involvement do not generally extend beyond the investment committee’s allocation of the exploration budget, leaving the exploration function to decide autonomously how it should spend the budget, perform the exploration functions and manage/control the risks, in order to deliver value to itself and the wider group.

---

\(^1\) A mineral deposit at a site with no existing mining operations that has the potential to develop into a tier 1 (i.e. high-quality) mining asset.

\(^2\) Discovery in Mineral Exploration by Stephen B. Bartrop & Pietro Guj, Western Australia School of Mines – June 2009
46. We feel that Paragraph 66 is written from the point of view of profit-making enterprises, when it states that financial capacity is a relevant, but not a determinative factor in considering the allocation of risk return. It does not appear that consideration has been given to losses. In the event of losses, pre-existing financial capacity is key to an enterprise’s ability to survive. If that capacity is not already in place when the loss crystallises, it may not be possible to acquire it on a timely basis, potentially resulting in insolvency or administration. The events of 2008 demonstrate that an entity bearing losses cannot always rely on other group enterprises to provide additional capacity. For an entity that bears risks, a lack of such financial capacity could lead to a statutory audit qualification as a going concern, and would certainly cause significant difficulties for the Board of Directors of the entity. We would therefore suggest that the question of financial capacity is reconsidered and more emphasis is placed on its contribution.

47. We welcome the acknowledgement in Paragraph 67 that there are risks that can be transferred for an arm’s length fee. We are, however, concerned that the use of the word “some” in the Paragraph suggests that this is more the exception than the norm. In line with this, we question the implication later in this paragraph that a full transfer of core risks is unlikely to happen at arm’s length. The paragraph seems to assume that some risks, such as strategic, marketplace, infrastructure and operational risks, are more fixed than other risks and that they subsequently cannot be transferred at arm’s length between dependent (or independent parties). Although some risks clearly are fixed in the sense that they, for example, relate to a particular market, the paragraph fails to identify that the allocation of risk is not a question of transferring the risk as such. Instead, it is a question of transferring the liability of a risk. Certainly, in third party situations, you can observe that the liability for certain market related risks are transferred to parties not operating physically in that market. Likewise, the liability to assume infrastructure risk may very well be allocated among third parties even though the risk itself geographically may be hard to relocate. On this basis, we believe that this paragraph should be reviewed. In the context of the insurance industry, risk is a core component of the business. Risk transfers by means of reinsurance (both third party and intra-group) happen on a continuous basis.

48. As an example for proposed inclusion: in the financial services sector risk is routinely traded. The party assuming the risk is not in a position to control or manage the risks underlying that risk transfer. Put another way, risk can be packaged up and traded, bifurcating the underlying risk with the control or management of that risk. As an example, credit default swaps (CDS) are market instruments exhibiting these characteristics and in a default scenario, the purchaser of the CDS assumes the financial cost of the full risk without controlling or managing any aspect of the risk itself. As a result, since such market traded instruments exist in commercial markets, MNEs should not be restricted from providing comparable instruments internally within the group. The main point is that there is a market for risk management, and there is a market for risk-taking. Other examples include FX deals, interest rate derivatives, insurance and reinsurance products.

49. We appreciate the guidance in Paragraph 78 concerning the circumstances in which profits should be adjusted as a result of differences in ex-ante and ex-post pricing. It would be helpful if some more clarification could be given as ex-post pricing is not appropriate in many situations. For example, the insurance industry is based on risk and probability, it would not be appropriate to retrospectively adjust Transfer Pricing outcomes for insurance.
Interpretation and Non-recognition

50. Certainty is a key concern for MNEs in their relationships with tax administrations and their reporting of financial results to the market and investors. Where international transactions are concerned, consistency of application of tax rules by different jurisdictions is critical: it is in no one’s interests to have multiple cross-jurisdictional disputes. Therefore, any decision not to recognise a transaction should be taken with the utmost care and an understanding of the consequences, both for the counterparty tax administration and the taxpayer. Bearing this in mind, we feel that whilst it is helpful that the criteria for non-recognition set out in Section D4 and Section D3 stress every effort should be made to recognise the actual transaction, the proposed Guidelines do not contain sufficient safeguards to prevent compliant taxpayers being erroneously swept into non-recognition. It would be helpful if the comments in Paragraph 82 could be strengthened with an acknowledgement that non-recognition should be used only as a last resort, and that there is no policy intention to increase cases of re-characterisation. We would also welcome threshold guidance on what constitutes non-recognition as opposed to a re-pricing of the transactions as structured.

51. Pricing adjustments should be considered and used wherever possible before non recognition is contemplated. When a pricing adjustment or non recognition lead to the same outcome, the pricing adjustment approach should be used in preference, as this will increase the likelihood of corresponding tax authorities reaching agreement on the issue, and reduce the incidence of double taxation. This approach would also mitigate the potential implications of secondary and follow on adjustments described below at Paragraph 69. On the point of corresponding tax authority acceptance, before non recognition is imposed, we would recommend that the imposing tax authority should have a preliminary MAP/Treaty discussion with the corresponding tax authority to ensure that any double taxation issue that might arise can be resolved under the MAP process.

52. We are concerned about the inference tax administrations may draw from the wording of Paragraphs 85 – 87. The majority of MNEs are compliant taxpayers who wish to build good working relationships with tax authorities and have certainty in their tax affairs. These paragraphs appear to start from the premise that all MNEs establish complex and fragmented structures in order to manipulate their Transfer Pricing outcomes. Whilst this may be true in individual minority cases, in the last ten years, many MNE groups have taken significant steps towards simplification and reduction in the number of legal entities. We would suggest a change in emphasis to recognise that most MNEs do not engage in fragmentation merely to obtain a particular Transfer Pricing outcome, but that other commercial factors also dictate the organisation and structure of MNE groups.

53. Whilst we accept that the practice noted in Paragraph 88 of finding a price, rather than further investigating the commercial rationality of a transaction, may theoretically have its limitations, the fact remains that it is a pragmatic solution to a difficult and highly theoretical issue. In terms of time and resource allocation, it may be preferable from a cost-benefit point of view to retain the possibility of reaching agreement on this basis, rather than closing it down as an option.

54. As the consequences associated with the existence of “fundamental economic attributes” are very significant, further guidance on how the OECD expects MNEs to “exhibit” such attributes in Paragraph 89 would be welcome.
55. Paragraph 89 notes that fundamental economic attributes “would offer both of the parties the opportunity to enhance or protect their commercial and financial positions.” This is a very broad statement and may be open to differing interpretations as to what constitutes ‘enhancing’ or ‘protecting’ a commercial or financial position. It would therefore be very helpful to expand this section to give some examples of how it should be read so there is consistency in interpretation between different tax authorities and MNEs.

56. The inclusion of examples may assist MNEs in formulating and implementing Transfer Pricing policies, and help tax administrations in auditing those policies. Although carefully drafted, we believe that the example outlined in paragraphs 90 and 91 does not establish clearly enough why the facts and circumstances presented should be considered “fundamentally uneconomic”, illustrating the difficulty in providing proper and reliable guidance. The example overlooks the implications of the fact that S1 is receiving 400mUSD as an up-front payment for the intellectual property. Depending on the financial and cash-flow position of S1, it may very well be at arm’s length willing to make the trade-off outlined in the example in order to avoid a financial crisis or even bankruptcy. This clearly illustrates the risks with oversimplified examples which do not appropriately consider all aspects of today’s complex business environment.

57. It is surprising that the examples in Paragraph 90 and 91 relate to recharacterisation, as these could be viewed as typical examples of a business restructuring transaction. In business restructuring, the transaction is not ignored, it is either repriced or subject to non Transfer Pricing regulations, such as exit costs. We believe that the conclusion set out in Paragraph 92 is inconsistent with Chapter IX of the Guidelines on Business Restructuring, which also includes an analysis of risk. For reasons of clarity and to avoid duplication, we would propose that the sections of Chapter IX relating to risk and the new proposals for risk in Chapter I are reviewed jointly to ensure they are consistent.

58. Paragraphs 89 and 92 appear to introduce a new element to the Guidelines, which is to compare the pre- and post-tax results of the Group. This seems to be a move away from the arm’s length principle, which focuses on how a third party would price a transaction and has not – to date – taken account of post-tax results (even if such information regarding third parties were available). We do not see the post-tax result of the group as a relevant factor in determining the price of the transaction, but rather, as an element to price or influence future transactions between the parties. The Guidelines should, as far as possible, establish a framework that represents a practical interpretation of how parties would act at arm’s length.

59. Without detailed and considered analysis, there is a risk that the insertion of highly theoretical economic concepts such as moral hazard into the Guidelines could have unknown and unintended consequences.

60. With regard to Question 1, whilst we accept the concept of moral hazard and recognise that it can play a role in certain business transactions, it is not always the case that third parties will only accept risk if they can incorporate safeguards or incentives into contractual arrangements. By attempting to incorporate moral hazard into the Guidelines and implying that related party transactions do not exhibit moral hazard in the same way as unrelated parties, the Discussion Draft risks rendering the arm’s length principle not applicable to a wide
range of transactions. Our understanding is that a move away from the arm’s length principle is contrary to the aims of the BEPS project, which recognises that the arm’s length principle remains the best available and most widely accepted basis for Transfer Pricing methodologies.

61. In stating that individual entities will only act in the best interests of the group, the Discussion Draft takes a simplistic view of how associated entities act. Although this may be correct in some cases, MNEs differ in their organisation and at a micro level, especially in a more autonomous MNE, associated entities may behave very much like independent parties when personal performance, bonus or adherence to projected budgets is at stake. This is even more prevalent in MNEs that conduct their operations extensively through JVs with third parties or through companies with large minority or public shareholder interests.

62. The business of insurance is a case in point: in an insurance transaction a third party (the insurer) takes on risk over which it has neither control nor the contractual ability to impact the risk - particularly in the case of earthquake or other natural catastrophe insurance - in return for the payment of a premium. So effectively, the moral hazard is traded for risk-return: the insurer takes on risk over which it has no control and therefore takes on moral hazard, but at a high price to the party laying off the risk. Simply put, the moral hazard risk is reflected in the market premium charged.

63. There are numerous other examples in the market of transactions entered into by third parties where risk is neither controlled nor managed, while the party who assumes the contractual risk still enjoys the risk-reward trade-off that follows. Examples include:

   a. Home mortgage securitizations
   b. Where governments implicitly or explicitly guarantee banking organizations that engage in transactions involving risk
   c. Compensation structures that protect risk-taking employees from the consequences of their risks

64. Although moral hazard exists in certain third party transactions, it does not exist in all. It is therefore very difficult under the arm’s length principle to know when moral hazard should be imputed in a group context.

Risk – Return

65. With regard to Question 4, we believe that transactions between associated enterprises that solely transfer risk should be recognised. An example of such a transaction would be intra-group reinsurance. Reinsurance exists both as a third party and a related party transaction. The terms of both transactions are identical – the transfer of risk from one party to another – and the pricing is performed under identical methodologies. Other similar transactions include all hedging activities (to re-locate/centralise/manage FX, interest rate or credit risk etc.) and related party guarantees. We are concerned that, as drafted, the proposed Guidelines may allow tax administrations to disregard related party transactions where a risky stream of income is traded for an equivalent, less risky income stream, even though – as noted above – such transactions frequently occur between third parties. Under the arm’s length principle such related party transactions should continue to be recognised.
66. Another example where the transfer of risk(s) may well be reasonable may be upon the 
acquisition of an external business. Depending on how the business is set up prior to 
acquisition (for example, its control structure, authority levels, risk management structures, 
financial steering principles etc.), compared to the arrangements subsequent to the 
acquisition, it may be unreasonable to allocate the same risk profile to the business before and 
after the transaction. If, for example, a stand-alone entity is acquired by a large MNE, the 
acquired business will typically become subject to a large range of central governance rules, 
financial steering principles and management policies. In such a case, due to the integration 
of the new business into the MNE, a functional analysis may very well show that the full risk 
profile of the business pre-acquisition may not reflect the commercially rational position after 
the acquisition. In such a case, even though there are no other formal transactions, it may very 
well be reasonable, in alignment with the arm’s length, for risk(s) to be transferred.

67. The concept of risk return trade off raises some interesting questions. For example, the 
statement “the discount rate applied to the anticipated nominal income provides a link in 
deciding whether the seller is better off in the selling or retaining the asset” is not explained in 
detail, and would benefit from further clarification. The assumption would be that if an entity 
reduces its risk and accepts a lower return, by doing so, it should reduce its WACC and 
discount rate. Therefore, when the reduced return is considered using the lower discount rate, 
the entity is in a similar or better NPV position. The WACC question also goes to the split of 
debt and equity and what is the optimum level of each?

68. In relation to Question 5, the example at Paragraphs 90-91 has a number of issues. Whilst it is 
clear which transactions this is seeking to catch, the example is somewhat complex and is 
unlikely to be seen in practice. It does not address how the initial $400m is to be treated if the 
transaction is not to be recognised. The lump sum payment may have resulted in tax for 
company S1, which would need to be reversed. In addition, if the $400m is not returned to S2 
for a number of years (which is probable, if indeed it is returned at all), a tax adjustment is 
needed for S1 to reflect the tax that it will have earned income on the $400m (potentially 
through other investments) or reduced its deductible costs, e.g. by reducing its debt balance 
and thus its interest payments. We would therefore welcome further guidance on how not 
only the primary consequences are dealt with (e.g. how is the royalty payment dealt with if 
not recognised), but also how the secondary and other consequences are dealt with (e.g. the 
lump sum payment and the lost opportunity cost of the investment or the reduced debt). 
These secondary and other consequences of non-recognition indicate the additional 
complexity of applying non-recognition versus an adjustment to pricing and highlight the 
likelihood of double taxation.

69. For Question 8, the insurance sector is discussed separately in a subsequent section (see 
paragraphs 97 to 118).

Special Measures

70. The existence of special measures, in addition to non-recognition, creates further uncertainty 
for taxpayers. We believe that the analysis of commercial and financial relations set out in 
Sections D1 and D2 followed, where necessary, by the application of non-recognition in 
Sections D3 and D4 should be sufficient to ensure that Transfer Pricing outcomes are in line 
with value creation and therefore, special measures are not required.
We do not believe that any special measures should be adopted without further development of the proposals across the BEPS Action Plan. It should first be understood how those wider proposals tackle Governments’ specific BEPS concerns before new special measures are introduced. Using this approach, it would be possible to identify specific residual issues so that future rules could be well defined and targeted.

With regard to the information asymmetry mentioned in Paragraph 3, we believe that BEPS Action 13 on Transfer Pricing Documentation and Country-by-Country Reporting, together with the information sharing it promotes, significantly reduces the risk of information asymmetry. The documentation required by Action 13 gives tax administrations the necessary tools to conduct risk assessments and commence audits and again obviates the need for special measures.

Section D1 focuses very much on functionality and actual capabilities/conduct. The existence of minimal functional entities referred to in Paragraph 3 could therefore be analysed under Section D. It is difficult to see why additional measures are required to deal with such entities.

If special measures are to exist, then there must be a clear and consistently applied set of criteria for their application and an unambiguous gateway for entry into them and sequencing rules to determine when they should apply in the place of the broader Guidelines. In the absence of clear criteria, each tax administration will interpret the provisions individually, which will result in inconsistent application, a significant increase in disputes and potential double taxation.

We are concerned that Paragraph 6 appears to disregard the arm’s length principle for the sake of achieving a specific result. We consider that any move away from the arm’s length principle is detrimental to the existing international agreement around the use of Transfer Pricing methodologies. If we begin to define circumstances in which the principle does not apply, then the underlying principle itself may come to be questioned.

With regard to Framework Question 7, we believe special measures should be considered only after the application of normal Transfer Pricing rules. As noted above, we believe all situations can be dealt with under the existing Guidelines. It is hard to envisage a circumstance in which those Guidelines could be ignored and special measures applied immediately. One of the criteria for applying special measures must be that all efforts under the existing Guidelines have been exhausted by taxpayers and tax administrations. A second criterion to be satisfied would be that the matter has been referred to Competent Authorities, but they have been unable to resolve the issue through a Mutual Agreement Procedure.

With regard to Framework Question 8, significant consideration must be given to preventing the possibility of double taxation due to disputes arising from the application of special measures, and a mechanism must be identified to deal with this. Given the complexity of the situations likely to be covered by special measures we believe that the existing mutual agreement procedures would be severely stretched in trying to cope with the additional work. We therefore suggest that if special measures are to be implemented, one of the requirements should be that any resulting cross-border disputes are granted priority by tax administrations.
78. With regard to Framework Question 9, we believe that the Financial Services sector should be excluded from the measures focused on capital. Please see Paragraph 97 to 118 for a further discussion of capital in the Financial Services sector.

**Hard-to-value intangibles (Option 1)**

79. We do not see the benefit of complicating the discussions on hard to value intangibles beyond what will be included in the Guidelines for Intangibles. It is not clear to us whether this section proposes a new valuation methodology in case of an intangible that produces a more significant return than initially expected (which can also happen in third party situations), or if the Discussion Draft is trying to shift the burden of proof to the taxpayer in cases where projections do not crystallise, which would be a significant change to current regulations in OECD countries, or if this should be seen as a ‘penalty’ in case the tax authorities see the Transfer Pricing documentation as unsatisfactory. We would welcome clarification on this section and its main objective.

80. Intangibles may be transferred between third parties for lump sum amounts. This may happen through the straightforward purchase of the intangible, or by the takeover of a company (coupled with a transfer of the intangible to a different location at the same or similar price). In both instances, there may be no future adjustment with both parties living with the consequences. Therefore, it appears strange that the starting point is the transfer for a fixed price.

81. When considering a retrospective price adjustment, consideration should be given to the development or value added by the new owner in the intervening period since the original sale of the intangible. A distinction should be made between the return due to the original owner and that due to the current owner.

82. If this approach is considered necessary, **very clear and objective criteria need to be developed to determine how and when the rule should apply.**

**Inappropriate returns for providing capital (Options 2 and 3)**

83. In considering inappropriate returns for capital, the special measure does not appear to take account of potential losses. We also believe that any BEPS related work that considers capital structures of MNEs should be closely coordinated with the work under Action 4 – which may satisfactorily address government concerns.

84. We believe that this measure should not apply to MNEs in Financial Services sector groups as capital is a key component of their business. Efficient management of capital is a key competitive advantage in this sector and therefore, entities are highly unlikely to be over-capitalised. A group or fixed ratio would not be appropriate. It should be noted that capital adequacy requirements would also not be appropriate, as they are a regulatory minimum and are often not sufficient for a FS entity to actually undertake business. In order to do business, a FS entity requires additional capital to satisfy the ratings agencies and any further margin imposed by its regulator.

85. The independent investor approach appears to be rather subjective and leaves much opportunity for differing views between tax authorities and taxpayers or even between
different tax authorities. The extent to which this option would help taxpayers or tax authorities come to an agreed position is unclear, and may even be detrimental to achieving it.

86. The starting point for the thick capitalisation option appears to be an arbitrary capital ratio that may be based on a group ratio. Different MNEs in differing industries have vastly different capital ratios. Furthermore MNEs that have multiple businesses could have a blended capital ratio that bears no relationship to any of the individual standalone businesses.

87. Neither option takes account of potential Joint Venture agreements, or production sharing agreements where debt financing is not permitted. Consideration also needs to be given to territories that have adopted Sharia law, where interest is not recognised. It is not clear from the thick capitalisation option how a group attribution would overlay on the legal form in such cases and how this might, in the case of a Joint Venture, lead to a disproportionate allocation of funding.

88. The thick capitalisation option makes the assumption that all tax authorities involved would interpret and apply the proposed rule in the same way and that a corresponding adjustment would be available on both sides. If this is not the case – and it is likely that an issue of this type would be disputed – then there is significant potential for double taxation.

89. We would note that BEPS Action 4 on Interest Deductions is also concerned with the capital structure of MNEs, although Action 4 is focused on debt rather than equity. We believe it is not appropriate to treat these two capital elements in isolation and that work on Options 2 and 3 should be co-ordinated with Action 4. Jointly these considerations may have a significant impact on capital structures and without such co-ordination there may be unintended macro-economic consequences.

Minimal functional entity (MFE) (Option 4)

90. The Discussion Draft states that “it may prove simpler and more effective, therefore, in dealing with such cases [i.e. for minimal functional entities lacking fundamental economic attributes] to adopt a targeted special measure.” Although we support clear and practical rules, it should not be the case that ‘simplicity’ over ‘complexity’ should be the deciding factor over when a special measure should apply. It is our concern that governments may see such special measures as generally providing a more ‘simple and effective’ approach, and that this could undermine the more detailed and principled framework in the remainder of the Guidelines that is generally applied by taxpayers to reach a reliable conclusion.

91. MNEs may, in many cases, centralize third-party debt in the parent entity or an affiliate resident in the parent country. There are many reasons for this including the desire to borrow in the home country currency or creditors’ desire to have the assets of the group available to fund the repayment of the debt. The proposals in the Action 4 – Interest Deductions Discussion Draft, particularly the group wide ratio, would essentially require MNEs to establish financing entities to manage their interest expense by pushing debt down to affiliated entities. The financing entities may neither need nor have full time employees. This Discussion Draft may be read as not recognizing these transactions or applying special measures to them. Thus, the proposals in the two Discussion Drafts may be working at cross purposes. That is, if MNEs must establish financing entities to manage their interest deductions, then those entities must be permitted to earn a time value of money return regardless of whether they
are considered “minimally functional”. Both the Discussion Draft on interest deductibility and this Discussion Draft should be clear that such entities earning a time value of money return do not raise issues under non-recognition or special measures notwithstanding their passive nature.

92. We disagree with the thresholds of functionality contained in this section. We do not believe that “qualitative attributes” can play a role in assessing whether or not an arrangement is lacking fundamental attributes. Whilst we recognise that the presence of assets, people, capital and functions is relevant, we believe it may be the case that a group entity “lacks functional capacity to create value through exploiting its assets and managing its risk and is mainly reliant on a framework of arrangements with other group companies to exploit its assets and manage its risks”. For example, hedge funds often operate with relatively few, high value fund managers and partners investing substantial amounts of investors’ capital in financial markets with significant risk. The draft guidance on MFEs would seem to suggest that such entities may be problematic. This inability to run a business outside the group may even be the main characteristic of a group company (e.g. a R&D Centre). We believe the wording should instead refer to the ability of the company to carry out its business.

93. The option does not give due consideration to operational efficiency. There is a risk with this proposal that an efficient, but lean, entity would be considered an MFE. We would question why this option seems to require a fully competitive market within a group context, when it could be a sign of efficiency that certain entities are lean.

94. We are concerned that the ‘mandatory profit split... based on pre-determined factors’ could in reality become formulary apportionment.

Ensuring appropriate taxation of excess returns (Option 5)

95. Whilst we believe that Options 1 to 4 can be dealt with using Sections D1 to D4 of the Guidelines, Option 5 falls outside Transfer Pricing. In principle we have no objection to the use of controlled foreign corporation (CFC) measures as a means to prevent BEPS, although we believe significant further work is required to develop the primary and secondary rules set out in Option 5, as these are very broadly drafted. In particular the allocation of taxing rights to various jurisdictions would need to be carefully considered.

Sector Specific Comments

Insurance Sector

96. In response to questions in the Discussion Draft we have commented in detail below on two areas:

- The discussion of risk in the Discussion Draft is too general in nature to apply to the insurance sector, where risk and risk transfer are the core of the business
- Operating in a regulated sector, insurance MNEs do not have the freedom to control their capital and legal structures

97. The business of insurance is the transfer of risk from the insured party to the insurer, in return for the payment of a premium. The insurer assesses the risk in the context of the likelihood of
the loss event and the pool of other risks held by the insurer. By pooling risks across various geographies and sectors the insurer can diversify risk and spread the risk of loss.

98. In order to bear the risk of loss – i.e. to ensure that claims can be paid out to policyholders – regulators require insurers to hold an appropriate amount of capital. The regulator acts to protect policyholders in their jurisdiction and ensure sufficient capital is available in that jurisdiction to cover any unexpected losses. In addition to this minimum regulatory capital requirement, ratings agencies also impose capital conditions in order for an entity to attain or maintain a specific credit rating. The level of credit rating is key as it opens access to particular customers and markets who will not deal with entities that have a credit rating lower than Y. Maintaining the required level of capital in a particular entity is, therefore, not a question of choice but is critical to the ability to do business. In addition to these two requirements it is common for regulators to impose a further ‘buffer’ or margin over and above the minimum capital requirement. Again the insurer has no choice in this matter as it needs an insurance licence to do business and if it does not meet the regulator’s requirements the licence will be withdrawn.

99. Similarly the insurer often has no choice over the legal structure it must adopt in a particular jurisdiction. Some regulators may allow a permanent establishment, others may require a subsidiary, but the permitted activities and capabilities of staff in those entities are closely governed by the regulator; for example the issuance of policies often cannot be done by a foreign entity.

100. Capital is needed to back risk, but it is a scarce resource and thus is expensive. In the insurance sector this is exacerbated by the requirements from regulators, ratings agencies and customers to hold ‘high quality’ capital – i.e. capital in the form of assets that are more secure and therefore more expensive to hold.

101. For insurance MNEs there is a balance that continually needs to be struck between the demands of regulators and ratings agencies to hold relatively large amounts of capital and the fact that holding capital is expensive. Holding high quality capital is costly, which means lower profits, which in turn diminishes the returns available to satisfy and retain investors. This constant juggling means there is every incentive for an insurance MNE to hold the minimum possible capital rather than over-capitalising. The ability to manage capital efficiently is a key source of competitive advantage in the sector.

102. The most common way of managing the balance between bearing risk and the need to hold capital to support that risk is through the use of reinsurance arrangements. Under a reinsurance arrangement a large single risk, or a group of risks is transferred from the insurer to another insurer (the reinsurer) in return for payment of a premium. The original insurer no longer bears the risk and therefore is not required to hold capital against it. The risk and the associated capital requirement have been transferred to the reinsurer.

103. Reinsurers exist both as third parties and in a group context. Like insurers they and the arrangements they enter into are regulated. Irrespective of whether a reinsurance arrangement is with a third party or a group entity, in order for the arrangement to be recognised and thus remove risk (and associated capital) from the originating insurer the arrangement must comply with regulatory and accounting requirements. It must genuinely transfer risk and must be with a sufficiently capitalised counterparty (again the regulator is
acting to protect policyholders in its jurisdiction, ensuring that the reinsurer is sufficiently
capitalised to meet claims).

104. In accordance with Part IV of the Attribution of Profits to Permanent Establishments 4 (“Part
IV”), profits and losses in the insurance industry are attributed to the KERT function which, for
both insurers and reinsurers, is those people who select and price risks. As noted above, in the
insurance business the bearing of risk and the holding of capital go together and thus the
location in which the KERT function takes place is also the location in which the capital is held.
In order to avoid any confusion between Part IV and the proposed framework for allocating
risks contained in the Discussion Draft we would suggest that Section D2 on risk clarifies the
precedence of Part IV in respect of the insurance sector.

105. Reinsurance within a group – i.e. reinsuring with another group entity – offers additional
benefits over and above third party reinsurance:

106. Pooling risks in a central group entity has the effect of diversifying those risks – i.e. spreading
the risk of loss, which means the capital requirements are lower. The more centralisation of
risk a group can achieve, the less capital it is required to hold and the lower its cost of capital
in relation to the business it can undertake. With a lower cost of capital the group can offer
lower prices to customers

107. It is more flexible to hold capital centrally. Rather capitalising each individual jurisdiction
(which would be expensive), capital held centrally can be used via reinsurance to support
business in multiple jurisdictions.

108. Capital held centrally can be deployed very quickly if necessary to support a particular
jurisdiction

109. Centralising capital also improves liquidity management, as it can give more flexibility around
the type of assets held and, in the event of a large loss, can give access to a larger pool of
liquidity to settle claims

110. Centralising risks in one location enables the group to negotiate better rates of reinsurance
with third parties, rather than each individual group entity entering into separate
arrangements with third party reinsurers in respect of several smaller pools of risk

111. As noted above, the regulator’s primary concern is that policyholders are protected and
therefore the regulator will review reinsurance contracts to ensure the terms and conditions,
capital and credit-worthiness of the reinsurer meet regulatory requirements. This is
irrespective of whether the reinsurance is third party or intra-group. Intra-group transfers of
risk for reinsurance purposes are therefore real transfers of risk and are not distinguishable
from third party reinsurance arrangements. In response to question 4 under Risk-return trade-
off we believe that intra-group reinsurance is a transaction that should be recognised for
Transfer Pricing purposes.

112. The points made above relating to reinsurance apply equally to insurance.

4 Part IV, 2010 OECD Report on the Attribution of Profits to Permanent Establishments
Submitted by email: TransferPricing@oecd.org


Through its members, BUSINESSEUROPE represents 20 million European small, medium and large companies. BUSINESSEUROPE’s members are 41 leading industrial and employers’ federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled “Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures)” 1 December 2014 – 6 February 2015 (hereinafter referred to as the Draft).

General Comments

BUSINESSEUROPE supports the OECD’s ambition to improve the existing guidance on risk and to assure that transfer pricing outcomes are in line with value creation. In particular, we welcome the ambition to provide further guidance about (i) the accurate delineation of the actual transactions based on both the contractual arrangements (as a starting point) and the conduct of parties (just if in practice deviates substantially from contractual arrangements), (ii) the specification of associated risks and allocations of risk to risk management (as long as it is relevant and it does not determine a disproportionate increase of compliance burden for tax payers), and (iii) the non-recognition of transactions which lack the fundamental attributes of arrangements between unrelated parties (to the extent that adequate measures are included to ensure proper application to cases arising). Regarding this last point, BUSINESSEUROPE welcomes additional guidance on what is considered by fundamental attributes of operations for the proper application of the measure. BUSINESSEUROPE agrees with the OECD that the mere contractual allocation of risk is not sufficient under the arm’s length principle. BUSINESSEUROPE is however concerned that several of the new standards set out in Part 1 of the discussion draft is overly onerous and ambiguous and that they would be very hard to comply with in
practice. In particular, the principles set out in section D.2. seem to require risk identification and valuation at a level of detail which is hardly manageable in practice. By way of example, benchmarking data is typically not available at the level of detail required to conduct the exhaustive risk analysis required throughout the document. In this context, it should be recalled that a fundamental reason for MNEs to adopt TP-models with centralized risk taking (and IP) is due to the very fact that risk (and IP) is often very difficult to identify and value at a detailed level (at least before it materializes). We are therefore concerned that taxpayers with the best intentions to comply with the arm’s length principles will fail or be seen to fail to comply with these new standards and hence face an increased risk of double taxation, disputes and/or re-characterisation.

BUSINESSEUROPE thinks that it should be clarified that the purpose of the measures included in Part I is just providing additional guidance to taxpayers on how to perform the functional analysis considering the risk factor and its treatment, in order to correctly delineate transactions, rather than avoiding BEPS.

Special care is needed to ensure that the proposed measures are aimed at reviewing actual conducts and risk allocation but in general terms they should not result in an increase of re-characterization of the transactions already analyzed by MNEs.

As a general comment, further explanations and introductory comments regarding the reasons and purpose of each example included throughout the guidance are welcomed in order to ensure that tax payers understand in each scenario the importance of risks and its allocation.

Additionally, although carefully drafted examples may assist taxpayers and tax authorities in the implementation and follow up of transfer pricing models and policies, we think that many of the examples are overly simplified and that the conclusions drawn are overlooking several important aspects in commercial transactions.

By way of example, although the example set out in paragraphs 90 and 91 may seem reasonable at first glance, it completely neglects the fact that S1 is receiving 400MUSD as an upfront payment for the IP. Depending on the financial status of S1 it may very well make the deal at the terms set out in the example at arm's length if the alternative is financial crisis or even bankruptcy. This clearly illustrates the difficulty and risk with using simplified examples to illustrate the complex commercial reality that companies are operating under in today’s global business environment.

If the examples are to be kept, BUSINESSEUROPE therefore believes that the paper should clearly underline that they are included for illustrative purposes only and that they frequently are not applicable to related transactions. Otherwise, the measures and examples proposed might create misunderstandings and disputes.

Regarding the potential special measures included in Part II, it should be remarked that the examples included are referred to very specific and limited related transactions in
which there is BEPS situation, which are not the general rule in the majority of the MNEs related party transactions.

In any case, the proposed measures are in a very embryonic stage and need further development so that they can be properly evaluated and thus contribute to the fight against BEPS situations.

The analysis of commercial and financial relations, together with (if necessary) the application of non-recognition rules, should be considered enough to guarantee a proper remuneration of the intragroup transactions within MNEs. Therefore, we consider that there would be no need for these special measures in order to avoid BEPS behaviours.

However, in case special measures are finally approved, we think it should be clearly expressed that they should apply only in exceptional cases. They should also be applied consistently by all tax Administrations in order to avoid an increase of tax disputes and potential double taxation.

Although, adjustment clauses are frequently used in acquisitions including IP, we see a risk that the suggestion in option 1 may open up for an arbitrary use of hindsight. We believe that a better approach is to include in the guidelines a recommendation to adopt adjustment clauses in cases where this can be expected in third party situations.

Although the drafting around options 2, 3 and 4 are still at a very embryonic stage, we fail to see how these options could be developed into rules which are sufficiently clear and adaptable to various market conditions and industries and which do not hamper genuine business activities.

Out of the suggested alternatives, we think that option 5 is the most reasonable one. Appropriately designed CFC-rules have the potential to mitigate important BEPS behaviour. Importantly, however, there needs to be a universal agreement on what is considered as an unacceptable tax level (and hence when CFC-taxation should be triggered).

A. REVISION TO SECTION D OF CHAPTER I OF TRANSFER PRICING GUIDELINES

1. Under the arm’s length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?

Since most moral hazard situations are caused due to the lack of information and/or market inefficiencies, as a general rule, they should not have a relevant role in transactions between related parties.
However, situations of moral hazard may occur in those sectors where risk taking is a key part of the business (i.e. insurance industry).

It should be noted that this kind of situations might occur because they are imposed by regulated markets, public bodies or even by the tax Administrations, which limit by law the maximum risks of the companies operating in its country in order to ensure tax collection.

In accordance to the arm's length principle, except for some specific risk-taking based industries, these situations shall be amended from a tax perspective by remunerating each related party in accordance with the risk and functions actually assumed in the transaction. This also implies that additional measures should be considered to avoid potential double taxation.

2. How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?

In the current economic environment many MNEs may not be unwilling to share insights about the core competencies due to the fact that they are conceived as integrated businesses; relevant implications arise from this scheme as related party transactions conducted by group companies will not always be perfectly comparable to those conducted by independent parties.

Although no clear answer can be provided by either tax Administrations or international organizations for every situation and the priority of the arm’s length principle is one of the fundamentals of transfer pricing, flexible approaches should be further analyzed in this regard.

Under this scenario, the limited functionality of one-sided transfer pricing methods has already been acknowledged by tax Administrations, international organizations and taxpayers, being therefore needed alternative approaches.

3. In the example at paragraphs 90 and 91 how should moral hazard implications be taken into account under the arm’s length principle?

Considering that the proposed scenario is based on tax nature reasons (low tax location involved) and not in business reasons, it is extremely difficult to justify a valuation of the intellectual property risks transferred to S2 under arm’s length principle.

However, in a scenario in which business reasons sustain the ownership transfer of an asset (for example, because there is a high specialization component), the mentioned transaction should be assessed under the arm’s length principle as a whole and attribute to S2 a portion of the results in accordance to the risk and functions assumed (similar to S1).
4. **Under the arm's length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognised, how should they be treated?**

MNEs transactions shall be based on economic and business reasons rather than on the sole effect of shifting risks between associated enterprises, particularly if low tax locations are involved. Thus, risks transfers can only be justified if there are economic or business reasons behind the transaction and such transfer is properly remunerated. As mentioned before, this may occur in those sectors where the risk taken is a key part of the business (i.e. insurance industry).

As a general rule, unless justified industry reasons are applicable, risk-return trade-off implications may be considered appropriate to value the risk and functions assumed by each related party under arm's length standard.

**5. In the example at paragraphs 90 and 91, how does the asset transfer alter the risks assumed by two associated enterprises under the arm's length principle?**

Compared to Company S1, Company S2 has less capability to manage and control the marketing which will affect the generation of expected income flows, and Company S2 has not a commercial position to enhance or to protect but it may damage it by not managing properly the asset-related risks.

In case of business reasons behind the example proposed, the mentioned transaction should be valued under arm’s length principle as a whole and attribute S2 a portion of the results in accordance to the risk and functions assumed by each party.

**6. In the example at paragraphs 90 and 91, how should risk-return trade-off implications be taken into account under the arm's length principle?**

As mentioned before, since the proposed example at paragraphs 90 and 91 is built over the existence of pure tax reasons, under the arm’s length principle it is difficult to determine the risk-return trade-off associated to the intellectual property transferred to S2.

In case business reasons were behind the example proposed, the mentioned transaction should be valued under arm’s length principle as a whole and attribute to S2 a portion of the results in accordance to the risk and functions assumed by each party.

Again, an appropriate functional analysis needs to be conducted in order to justify that the compensation attributed to each entity is aligned with its functional profile.
7. Under the arm’s length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk? If so:

Yes

a) Are there limits to the extent that the risk-return trade-off should be applied? For example, can the risk-return trade-off be applied opportunistically in practice to support transactions that result in BEPS (for example by manipulating the discount rates to “prove” that the transaction is economically rational)?

Yes, limits should be applied. Business reasons behind transactions are needed for implementing risk-return trade-off approach. No opportunistic applications that resulted in BEPS should be admitted.

For this purpose, it is relevant to avoid falling into probatio diabolica scenarios in which tax Administrations require taxpayers to make prove of situations in which there is a rational lack of evidence or a burdensome level of compliance.

b) Are there measures that can be taken in relation to the risk-return trade-off issue to ensure appropriate policy outcomes (including the avoidance of BEPS) within the arm’s length principle, or falling outside the arm’s length principle?

Under arm’s length principle appropriate outcomes are ensured by remunerating each entity in accordance with its functional and risk profile.

Measures outside the arm’s length principle should be avoided in order to guarantee a coherent and consistent transfer pricing system.

8. Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?

We understand that distinctions should be considered to financial services activities to the extent that risk is a core component of such industry. These distinctions should be settled under arm’s length principle in order to avoid uncertain environment in terms of taxation.

B. OPTIONS FOR SOME SPECIAL MEASURES

As initially exposed, the proposed measures are at a very early stage and further development would be needed so that they can really be evaluated.

Additionally, these extraordinary measures require special mechanisms to limit its application to those cases in which BEPS really occur and avoid double taxation of profits.
Option 1: Hard to value intangibles (HTVI)

1. How well does the measure achieve the policy goal of ensuring a closer alignment between transfer pricing outcomes and value creation? What other alternatives might be available to achieve the goal? What design options for the particular measure would improve the achievement of this goal?

Although the measure entails aligning transfer pricing outcomes and value creation, the remuneration agreed under this approach would not be arm’s length, since unrelated parties wouldn’t have designed the remuneration in that way at the time the transaction occurred. Therefore, this special measure should not be reconsidered by the OECD since it creates further uncertainty for taxpayers.

In case this new measure is finally adopted, it should be applied in very exceptional cases, to the extent that the valuation method adopted is not aligned with arm’s length principle.

In addition to other concepts, it is necessary to define what is meant by "robust projections" in order to implement the presumptions and establish some sort of guarantee to prove that the taxpayer has made reasonable efforts to make correct estimations based on the information available at the time the decision was taken (for example, technical reports issued by third parties validating that the estimations made by the company are reasonable at the moment they were proposed).

Finally, mechanisms for avoiding double taxation should be kept in all situations; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.

2. What are the advantages and disadvantages of the measure, and relative to other measures?

The measure entails aligning transfer pricing outcomes and value creation.

However, as mentioned, the valuation approach proposed seems to be against the arm’s length principle and introduces a high degree of uncertainty and subjectivity. Measures outside the arm’s length principle should be avoided in order to guarantee a coherent and consistent transfer pricing system.

In addition and as indicated earlier, although adjustment clauses are frequently used in acquisitions including IP, we see a risk that the suggestion in option 1 may open up for an arbitrary use of hindsight. We believe that a better approach is to include in the guidelines a recommendation to adopt adjustment clauses in cases where this can be expected in third party situations.
3. What is the likely effect of the measure? Will it operate mainly as a deterrent and encourage behavioural changes, or will it require compliance and reporting? What issues are likely to arise in complying with and in administering the measure?

It is likely that the measures proposed could operate as a deterrent for BEPS situation. However, the measures seem far from proportionate since the administrative burden and cost for taxpayers would be very high. It obliges taxpayers to prove a posteriori that valuation made a priori was right, being otherwise and adjustment made.

4. Given the targeted circumstances in which the measure would apply, in what ways can transfer pricing rules and guidance or other rules be further adapted to target such circumstances in parallel to or as an alternative to this measure?

The measures proposed for these specific circumstances are not aligned with TP rules and guidance. Thus, the measure proposed is an alternative to TP rules. Regarding hard to value intangibles, the proposed measure should be framed within the existing transfer pricing rules; even when no reliable comparable exist and a valuation is conducted, assumptions and hypothesis considered should be determined in accordance with the market practices.

Abandoning the use of the arm’s length principles would lead us to an uncertain environment in terms of taxation that could generate undesirable consequences and even aggressive tax planning (in the absence of a common framework, MNE would tend to implement other structures without considering value creation).

5. How well does the measure target the focus of its application? What criteria for application of the measure, and other thresholds, should be considered to improve clarity of application? In particular what design features of the options will secure the likelihood that tax administrations, when considering the facts of a given case in the context of audit or competent authority proceedings, will agree the case meets the criteria for application of the measure and on the resulting adjustment?

In case they are implemented, these new rules should be applied to very extraordinary and restricted number of cases, to the extent that the valuation method is against arm’s length principle.

Mechanisms for avoiding double taxation should be kept in all situations; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.
6. Where the measure makes no reference to tax attributes, should criteria be included limiting the measure to circumstances where the arrangement results in a tax advantage to the group?

As repeatedly stated by the OECD, the aim of these measures is to avoid BEPS and thus their applicability should be limited to those situations in which the arrangements within MNEs result in distorted taxation. In general terms MNEs organize their business in those territories where their economic activity is conducted, being taxed accordingly. Only extraordinary situation should be targeted by these measures.

7. In what order should the measures apply? Does the measure come into consideration following the application of normal transfer pricing rules, or should it be applied instead of transfer pricing rules?

The application of the generally accepted transfer pricing rules should be a boundary condition for the application of any further special measures, which should be considered as a last-resort; indeed, any development by the OECD should be defined within the scope of the arm’s length principle as it is the common ground accepted by all countries and the underlying principle in connection with the valuation of related party transactions.

Regarding hard to value intangibles, the proposed measure should be framed within the existing transfer pricing rules; even when no reliable comparable exist and a valuation is conducted, assumptions and hypothesis considered should be determined in accordance with market practices.

Abandoning the use of the arm’s length principle would lead us to an uncertain environment in terms of taxation that would generate undesirable consequences and even much more aggressive tax planning (in the absence of a common framework, MNE would tend to implement other structures without considering value creation).

8. Should mechanisms be available for eliminating double taxation, even if the rules are considered to be anti-abuse measures, and how should any such mechanisms be framed?

Mechanisms for avoiding double taxation should be kept in all situations; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.

9. Should certain sectors be excluded from the application of the measures? In particular, how should measures focussing on capital distinguish financial services activities where capital adequacy rules apply and where the amount of capital affects the amount of business that can be carried on?
Intangible valuations depend on the nature of the intangible itself as well as the related party affecting such intangible more than the sector in which the transaction is conducted.

10. What other measures would respondents wish to have considered, taking into account the policy goal of the BEPS Project, and what would the outline of such measures involve?

Considering the context of HTVI, both Tax Authorities and international organizations should be open-minded enough to accept alternative approaches for the purposes of valuing related party transactions affecting HTVI.

As regards the use of ex-ante information for intangibles valuation, this should be the general rule accepted and shared by all the industry players. Obliging the taxpayers to update their economic analysis with information that it is not available at the time the transactions in performed would result in an excessive administrative burden as well as a relevant (and unacceptable) increase of uncertainty in the valuation of their related party transactions.

Of course, the taxpayer should be ready to prove in front of the Tax Authorities that the information used for the valuation was accurate and objective at the moment the transaction was closed. Once this is ensured, no further reviews of the calculations by the taxpayers should be admissible.

**Option 2: Independent investor**

1. How well does the measure achieve the policy goal of ensuring a closer alignment between transfer pricing outcomes and value creation? What other alternatives might be available to achieve the goal? What design options for the particular measure would improve the achievement of this goal?

The measure proposed might entail aligning transfer pricing outcomes and value creation to the extent that the entity receiving the assets is not a low tax jurisdiction and there are business reasons behind the related transaction.

In practice, if approved, it should be stated that this special measure would be applicable to a very limited and justified number of cases since Tax Administrations will surely be tempted to apply this measure as a general rule.

The adoption of this new measure should be accompanied by the implementation of additional mechanisms to guarantee that double taxation doesn't occur in these specific transactions (i.e. taxation in S1country and S2 or P country).

2. What are the advantages and disadvantages of the measure, and relative to other measures?
The main advantage of the measure proposed is that it may imply an alignment between transfer pricing outcomes and value creation. However, again, it is needed to limit the application of this measure to those situations in which there are not business reasons behind transactions and BEPS occur.

Additionally, the proposed measure it is very theoretical and requires additional development and concretion. It is difficult to see how this option could be developed into a rule that is sufficiently clear and adaptable to various market conditions and industries so that it will not hamper genuine business activities. A generic application of the measure proposed and a lack of coordination between Tax Administrations can lead to double taxation situations.

3. What is the likely effect of the measure? Will it operate mainly as a deterrent and encourage behavioral changes, or will it require compliance and reporting? What issues are likely to arise in complying with and in administering the measure?

MNEs would probably need to invest additional costs in compliance and reporting activities because they would need to provide additional information that there are business reasons behind the transactions conducted by related parties.

4. Given the targeted circumstances in which the measure would apply, in what ways can transfer pricing rules and guidance or other rules be further adapted to target such circumstances in parallel to or as an alternative to this measure?

The measure proposed for “Independent investor” scenarios may have some room under the proposed revision to both Sections D.3 “Interpretation” and D.4 “Non recognition” of Chapter I of the Transfer Pricing Guidelines.

In addition, the application of this measure should rely on a thorough comparability analysis in order to identify function, risks and assets assumed/borne by each party and thus, the remuneration that should be granted to each of them according to their contribution.

5. How well does the measure target the focus of its application? What criteria for application of the measure, and other thresholds, should be considered to improve clarity of application? In particular what design features of the options will secure the likelihood that tax administrations, when considering the facts of a given case in the context of audit or competent authority proceedings, will agree the case meets the criteria for application of the measure and on the resulting adjustment?

The application of this measure should be limited to those cases in which there are not business reasons behind transactions conducted between related parties and there is a BEPS situation.
In any case, mechanisms for avoiding double taxation should be kept in all situations; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.

Again, the current status of this measure is very broad and generic and it is difficult to assess concrete consequences.

6. Where the measure makes no reference to tax attributes, should criteria be included limiting the measure to circumstances where the arrangement results in a tax advantage to the group?

As repeatedly stated by the OECD, the aim of these measures is to avoid BEPS and thus their applicability should be limited to those situations in which the arrangements within MNEs result in distorted taxation. In general terms MNEs organize their business in those territories where their economic activity is conducted, being taxed accordingly.

These measures should only apply in exceptional cases.

7. In what order should the measures apply? Does the measure come into consideration following the application of normal transfer pricing rules, or should it be applied instead of transfer pricing rules?

The application of the generally accepted transfer pricing rules should be a boundary condition for the application of any further measures; indeed, any development by the OECD should be defined within the scope of the arm’s length principle as it is the common ground accepted by countries and the underlying principle in connection with the valuation of related party transactions. In this case, the application of the measure should be based in a comparability analysis following the five OECD comparability factors.

Abandoning the use of the arm’s length principle would lead us to an uncertain environment in terms of taxation that could generate undesirable consequences and even much more aggressive tax planning (in the absence of a common framework, MNE would tend to implement other structures without considering value creation).

8. Should mechanisms be available for eliminating double taxation, even if the rules are considered to be anti-abuse measures, and how should any such mechanisms be framed?

Of course, mechanisms for avoiding double taxation should be kept in all situations; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.
9. **Should certain sectors be excluded from the application of the measures? In particular, how should measures focusing on capital distinguish financial services activities where capital adequacy rules apply and where the amount of capital affects the amount of business that can be carried on?**

We don't have comments on this.

10. **What other measures would respondents wish to have considered, taking into account the policy goal of the BEPS Project, and what would the outline of such measures involve?**

Both Tax Authorities and international organizations should be open-minded enough to accept alternative approaches for the purposes of valuing related party transactions.

Nevertheless, it is highly desirable that additional mechanism are in place for avoiding double taxation; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.

---

**Option 3: Thick capitalisation**

1. **How well does the measure achieve the policy goal of ensuring a closer alignment between transfer pricing outcomes and value creation? What other alternatives might be available to achieve the goal? What design options for the particular measure would improve the achievement of this goal?**

The measure proposed is far from aligning transfer pricing outcomes and value creation. We do not perceive the existence of BEPS situations in such cases to the extent that the capital contributed are related to the development of actual business activities.

Adopting measures to limit the maximum amount of capital contributions may hinder the implementation of MNE investment strategies. Taxation should not influence business decisions and must be configured as a neutral element.

In any case, further developments are required in the measures proposed (for example, adoption of a "predetermined capital ratio to each industry and country, based on a benchmarking of the market") so it can be properly analyzed and evaluated.

Additional mechanisms should be implemented to avoid double taxation due to the application of the measure proposed to this kind of transactions.

2. **What are the advantages and disadvantages of the measure, and relative to other measures?**
We do not foresee any advantage to the measure proposed to the extent that there are economic and business reasons behind capital contributions conducted by enterprises.

3. What is the likely effect of the measure? Will it operate mainly as a deterrent and encourage behavioural changes, or will it require compliance and reporting? What issues are likely to arise in complying with and in administering the measure?

MNE would probably need to invest additional costs in compliance and reporting activities because they would need to support with additional information that there are business reasons behind the transactions conducted by related parties.

4. Given the targeted circumstances in which the measure would apply, in what ways can transfer pricing rules and guidance or other rules be further adapted to target such circumstances in parallel to or as an alternative to this measure?

The measure proposed for "Thick capitalisation" scenarios may be included under the proposed revision of Sections D.3 "Interpretation" contained in Chapter I of the Transfer Pricing Guidelines.

5. How well does the measure target the focus of its application? What criteria for application of the measure, and other thresholds, should be considered to improve clarity of application? In particular what design features of the options will secure the likelihood that tax administrations, when considering the facts of a given case in the context of audit or competent authority proceedings, will agree the case meets the criteria for application of the measure and on the resulting adjustment?

The existence of BEPS situation and the absence of business economic reasons should be considered as a threshold to improve clarity of application.

Finally, additional mechanisms for avoiding the double taxation of this kind of transactions should be adopted to guarantee arm's length standards.

6. Where the measure makes no reference to tax attributes, should criteria be included limiting the measure to circumstances where the arrangement results in a tax advantage to the group?

As repeatedly stated by the OECD, the aim of these measures is to avoid BEPS and thus their applicability should be limited to those situations in which the arrangements within MNEs result in distorted taxation. In general terms MNEs organize their business in those territories where their economic activity is conducted, being taxed accordingly. These measures should only apply in exceptional cases.
7. In what order should the measures apply? Does the measure come into consideration following the application of normal transfer pricing rules, or should it be applied instead of transfer pricing rules?

The application of the generally accepted transfer pricing rules should be a boundary condition for the application of any further measures; indeed, any development by the OECD should be defined within the scope of the arm’s length principle as it is the common ground accepted by all countries and the underlying principle in connection with the valuation of related party transactions.

Abandoning the use of the arm’s length principles would lead us to an uncertain environment in terms of taxation that could generate undesirable consequences and even much more aggressive tax planning (in the absence of a common framework, MNE would tend to implement other structures without considering value creation).

8. Should mechanisms be available for eliminating double taxation, even if the rules are considered to be anti-abuse measures, and how should any such mechanisms be framed?

Mechanisms for avoiding double taxation should be kept in all situations; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as a relevant tool.

9. Should certain sectors be excluded from the application of the measures? In particular, how should measures focusing on capital distinguish financial services activities where capital adequacy rules apply and where the amount of capital affects the amount of business that can be carried on?

A further development is required to adapt the measure and definitions proposed to each industry and country particularities.

10. What other measures would respondents wish to have considered, taking into account the policy goal of the BEPS Project, and what would the outline of such measures involve?

Both Tax Authorities and international organizations should be open-minded enough to accept alternative approaches for the purposes of valuing related party transactions.

Nevertheless, it is highly desirable that additional mechanism are in place for avoiding double taxation; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.

Option 4: Minimal functional entity
1. How well does the measure achieve the policy goal of ensuring a closer alignment between transfer pricing outcomes and value creation? What other alternatives might be available to achieve the goal? What design options for the particular measure would improve the achievement of this goal?

The measure proposed could entail aligning transfer pricing outcomes and value creation. It is necessary to avoid generic thresholds that, in most cases, would not imply a BEPS situation neither the transfer of benefits to another tax jurisdiction.

Additionally, the actual economic and business reasons behind each transaction with related parties should be considered before the measure is applied.

However, as mentioned before, we do not consider necessary the implementation of special measures to fight against BEPS behaviour; the application of the current transfer pricing regulation would permit a thorough comparability analysis in order to identify function, risks and assets assumed/borne by each party and thus, the remuneration that should be granted to each of them according to their contribution.

2. What are the advantages and disadvantages of the measure, and relative to other measures?

The main advantage of the measure proposed is that its proper and accurate implementation can imply an alignment between transfer pricing outcomes and value creation. However criteria for development and implementation need to be more fully considered before this option could be supported.

Nevertheless, the proposed measure requires much development and concretion. We fail to see how this option could be developed into rules which are sufficiently clear and adaptable to various market conditions and industries and which do not hamper genuine business activities. A generic application of the measure proposed and a lack of coordination between tax Administrations can lead to double taxation scenarios. In addition it introduces a high degree of uncertainty for taxpayers; the return of a given entity should be based in its functional profile and not generic rules that do not take into consideration all the comparability factors stated by the OECD.

3. What is the likely effect of the measure? Will it operate mainly as a deterrent and encourage behavioural changes, or will it require compliance and reporting? What issues are likely to arise in complying with and in administering the measure?

MNEs would probably need to invest additional costs in compliance and reporting activities because they would need to provide additional information that these “minimal functions entities” are conduction business and paid in accordance with the actual functions and risk assumed.
In addition, we do not believe that this measure is necessary as the existing transfer pricing regulatory framework already permits avoiding BEPS situations.

4. Given the targeted circumstances in which the measure would apply, in what ways can transfer pricing rules and guidance or other rules be further adapted to target such circumstances in parallel to or as an alternative to this measure?

The measure proposed for “Minimal function entity” scenarios could be included under the proposed revision of Sections D.3 “Interpretation” contained in Chapter I of the Transfer Pricing Guidelines. However, the scenarios could better serve as examples demonstrating BEPS behaviour which may be better served as part of anti-avoidance rules.

5. How well does the measure target the focus of its application? What criteria for application of the measure, and other thresholds, should be considered to improve clarity of application? In particular what design features of the options will secure the likelihood that tax administrations, when considering the facts of a given case in the context of audit or competent authority proceedings, will agree the case meets the criteria for application of the measure and on the resulting adjustment?

The existence of BEPS situation and the absence of business economic reasons should be considered as a threshold to improve clarity of application.

Additional mechanisms for avoiding the double taxation of this kind of transactions should be adopted to guarantee arm’s length standards.

6. Where the measure makes no reference to tax attributes, should criteria be included limiting the measure to circumstances where the arrangement results in a tax advantage to the group?

As repeatedly stated by the OECD, the aim of these measures is to avoid BEPS and thus their applicability should be limited to those situations in which the arrangements within MNEs result in distorted taxation. In general terms MNEs organize their business in those territories where their economic activity is conducted, being taxed accordingly. These measures should only apply in exceptional cases.

7. In what order should the measures apply? Does the measure come into consideration following the application of normal transfer pricing rules, or should it be applied instead of transfer pricing rules?

The application of the generally accepted transfer pricing rules should be a boundary condition for the application of any further measures; indeed, any development by the OECD should be defined within the scope of the arm’s length principle as it is the common ground accepted by all countries and the underlying principle in connection with the valuation of related party transactions.
Abandoning the use of the arm's length principle would lead to an uncertain environment in terms of taxation that could generate undesirable consequences and even much more aggressive tax planning (in the absence of a common framework, MNE would tend to implement other structures without considering value creation).

8. Should mechanisms be available for eliminating double taxation, even if the rules are considered to be anti-abuse measures, and how should any such mechanisms be framed?

Definitively, yes. Mechanisms for avoiding double taxation should be developed in all situations; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.

9. Should certain sectors be excluded from the application of the measures? In particular, how should measures focussing on capital distinguish financial services activities where capital adequacy rules apply and where the amount of capital affects the amount of business that can be carried on?

We don't have comments on this.

10. What other measures would respondents wish to have considered, taking into account the policy goal of the BEPS Project, and what would the outline of such measures involve?

Both Tax Authorities and international organizations should be open-minded enough to accept alternative approaches for the purposes of valuing related party transactions.

Nevertheless, it is highly desirable that additional mechanism are in place for avoiding double taxation; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.

**Option 5: Ensuring appropriate taxation of excess returns**

1. How well does the measure achieve the policy goal of ensuring a closer alignment between transfer pricing outcomes and value creation? What other alternatives might be available to achieve the goal? What design options for the particular measure would improve the achievement of this goal?

The measure proposed could entail aligning transfer pricing outcomes and value creation. It is necessary to avoid generic thresholds that, in most cases, would not imply a BEPS situation neither the transfer of benefits to another tax jurisdiction.
Additionally, to make this measure applicable it would be necessary to define what is considered by "excess of benefit" and the circumstances that determine the application of "primary" and "secondary" rules in order to avoid uncertainties regarding the jurisdiction to which profits must be allocated.

Again, additional mechanisms for avoiding the double taxation of this kind of transactions should be adopted to guarantee arm's length standards.

2. What are the advantages and disadvantages of the measure, and relative to other measures?

The main advantage of the measure proposed is that in some specific cases it can imply an alignment between transfer pricing outcomes and value creation.

In the same way as in previous measures, the main disadvantage is that the proposed measure has to be detailed and developed in order to be applicable and solve real BEPS situations.

As mentioned in our general remarks, we believe that compared to the other options, option 5 is the most reasonable one. Appropriately designed CFC-rules has the potential to mitigate important BEPS behaviour. Importantly, however, there needs to be a universal agreement on what is considered as an unacceptable tax level (and hence when CFC-taxation should be triggered).

3. What is the likely effect of the measure? Will it operate mainly as a deterrent and encourage behavioral changes, or will it require compliance and reporting? What issues are likely to arise in complying with and administering the measure?

MNE would probably need to invest additional costs in compliance and reporting activities because it would be needed to support with additional information that this specific transactions are based on business reasons.

4. Given the targeted circumstances in which the measure would apply, in what ways can transfer pricing rules and guidance or other rules be further adapted to target such circumstances in parallel to or as an alternative to this measure?

The measure proposed for "Minimal function entity" scenarios may be included under the proposed revision of Sections D.3 "Interpretation" contained in Chapter I of the Transfer Pricing Guidelines.

Additionally, Profit split method will be applicable in order to re-allocate profits to each entity in accordance with their actual functions.
5. **How well does the measure target the focus of its application?** What criteria for application of the measure, and other thresholds, should be considered to improve clarity of application? In particular what design features of the options will secure the likelihood that tax administrations, when considering the facts of a given case in the context of audit or competent authority proceedings, will agree the case meets the criteria for application of the measure and on the resulting adjustment?

The application of this measure should be limited just to those cases in which there are not business reasons behind transactions conducted between related parties and there is a BEPS situation.

Again, mechanisms for avoiding double taxation should be kept in all situations; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.

6. **Where the measure makes no reference to tax attributes, should criteria be included limiting the measure to circumstances where the arrangement results in a tax advantage to the group?**

As repeatedly stated by the OECD, the aim of these measures is to avoid BEPS and thus their applicability should be limited to those situations in which the arrangements within MNEs result in distorted taxation. In general terms MNEs organize their business in those territories where their economic activity is conducted, being taxed accordingly. Only extraordinary situation should be refrained by using these measures.

7. **In what order should the measures apply?** Does the measure come into consideration following the application of normal transfer pricing rules, or should it be applied instead of transfer pricing rules?

The application of the generally accepted transfer pricing rules should be a boundary condition for the application of any further measures; indeed, any development by the OECD should be defined within the scope of the arm's length principle as it is the common ground accepted by all countries and the underlying principle in connection with the valuation of related party transactions.

Abandoning the use of the arm's length principle would lead to an uncertain environment in terms of taxation that could generate undesirable consequences and even much more aggressive tax planning (in the absence of a common framework, MNE would tend to implement other structures without considering value creation).

8. **Should mechanisms be available for eliminating double taxation, even if the rules are considered to be anti-abuse measures, and how should any such mechanisms be framed?**
Yes. Mechanisms for avoiding double taxation should be kept in all situations; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.

9. **Should certain sectors be excluded from the application of the measures? In particular, how should measures focusing on capital distinguish financial services activities where capital adequacy rules apply and where the amount of capital affects the amount of business that can be carried on?**

We don't have comments on this.

10. **What other measures would respondents wish to have considered, taking into account the policy goal of the BEPS Project, and what would the outline of such measures involve?**

Both Tax Authorities and international organizations should be open-minded enough in order to accept alternative approaches for the purposes of valuing related party transactions.

Nevertheless, it is highly desirable that additional mechanism are in place for avoiding double taxation; as long as anti-abuse measures are not adopted and implemented by all countries in similar terms, double taxation could be generated and therefore any mechanism to avoid it should be considered as relevant tools.

Consequently, we urge the OECD to carefully consider these aspects in the process ahead.

BUSINESSEUROPE would be willing to engage in a constructive dialogue with the OECD on risk recharacterisation and special measures.
On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

James Watson
Director
Economics Department
Dear Mr. Hickman:

Re: OECD Public Discussion Draft on BEPS Actions 8, 9 and 10 on the revision of Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation and Special Measures)

The Canadian Bankers Association\(^1\) (CBA) welcomes the opportunity to provide a submission on the OECD’s Public Discussion Draft on BEPS, Action 8, 9 and 10 on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures) dated December 19, 2014 (the “Discussion draft”). We bring the perspective of an industry characterized both by intense competition in Canada and the active involvement of our banks internationally.

The CBA is committed to contributing constructively to the BEPS project, in the expectation that the final outcome will deliver fair, certain, predictable, sustainable and principled rules that taxpayers can easily apply and tax authorities can easily administer.

The intention of the comments in this submission is to highlight the main concerns the CBA has with the proposal in the Discussion Draft.

Summary

The proposed changes to Chapter I of the OECD Transfer Pricing Guidelines (the “Guidelines”) attempt to sharpen the proverbial blade of the arm’s length principle and create a better knife to carve up the profits of a Multinational Enterprise (“MNE”) for tax purposes. The essence of the proposal is to ensure transfer pricing outcomes are in line with value creation and essentially shifts the focus from the contractual arrangements put in place by an MNE as a starting point of the transfer pricing

---

\(^1\) The Canadian Bankers Association works on behalf of 60 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.
analysis to determining the actual conduct of the parties to accurately delineate the transaction. This is then followed by interpretation of the facts to determine whether the transaction merits a pricing analysis or non-recognition. The discussion draft also suggests special measures for situations where the revised Guidelines cannot address remaining BEPS risks.

The CBA welcomes changes to the Guidelines that increase certainty for taxpayers by introducing clear, consistent and unambiguous approaches and criteria to address transfer pricing issues. However, it is our view that the Discussion Draft in its current state:

1. fails to align the guidance for applying the arm’s length principle under article 7 and article 9 of the OECD Model Tax Convention on Income and on Capital ("Model Tax Convention") , which is crucial because the Guidelines apply by analogy to determine the attribution of profit to a PE under article 7;

2. introduces additional terms and approaches that significantly increase the ability for tax administrations to apply subjective judgment to MNE’s facts and circumstances; and

3. introduces an assumption of BEPS behavior, while not considering the restrictions imposed by the regulatory environment that applies to certain industries, such as the financial services industry.

We strongly believe that by addressing these issues in a comprehensive manner, tax administrations and MNE’s will benefit from changes to the Guidelines and will help achieve the objectives of the BEPS initiative while reducing the risk of controversy and resulting uncertainty going forward. Should these issues not be addressed, the administrative burden for both tax administrations and MNE’s will significantly increase.

1) Aligning the guidance on transfer pricing analysis under article 7 and article 9

The comments contained in this section address the proposed changes in the Discussion Draft in general, as well as provide a response to question 8 in the Discussion Draft specific to the financial services industry.

From the perspective of financial institutions, it is striking how the functional analysis is positioned in the Discussion Draft as the tool to establish the conduct of the parties and contributions to value creation in the context of article 9 of the Model Tax Convention, in the same way the functional analysis is positioned as the tool to establish significant people functions and key entrepreneurial risk taking functions under article 7 for attribution of profits to a permanent establishment ("PE"). The guidance provided in Part I, section 10 of the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (the "PE Report") prescribes a two-step analysis (emphasis added):

“…First, a functional and factual analysis, conducted in accordance with the guidance found in the Guidelines, must be performed in order to hypothesise appropriately the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises. Under the first step, the functional and factual analysis must identify the economically significant activities and responsibilities undertaken by the PE. This analysis should, to the extent relevant, consider the PE’s activities and responsibilities in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the PE. Under the second step, the remuneration of any dealings between the hypothesised enterprises is determined by applying by analogy the Article 9 transfer pricing tools (as articulated in the Guidelines for separate enterprises) by reference to the functions performed, assets used and risk assumed by the hypothesised enterprises.”
The Discussion Draft suggests a very similar approach in section D1:

“2. [New] The process of identifying the commercial or financial relations between associated enterprises follows from examining contractual terms governing those relations together with the conduct of the parties. Establishing the conduct of the parties involves examination of all of the facts and circumstances surrounding how those enterprises interact with one another in their economic and commercial context to generate potential commercial value, how that interaction contributes to the rest of the value chain, and what the interaction involves in terms of the precise identification of the functions each party actually performs, the assets each party actually employs, and the risks each party actually assumes and manages.”

The approach suggested in the Discussion Draft to accurately delineate the transaction by focusing on the conduct of the parties followed by the interpretation of the facts leading to recognition and pricing of the transaction or non-recognition of the transaction is factually the same as the prescribed analysis in the PE Report through its focus on the functions performed by people employed by the MNE. Also note the resemblance between the proposed guidance for non-recognition of a transaction in the Discussion Draft and the criteria for recognition of dealings in the PE Report. Although arguably the similarities are not immediately apparent, when both documents are read in their entirety it seems that the OECD aims to achieve outcomes in the article 9 context that are the same as under article 7.

In the interest of fostering compliance, creating certainty and avoiding different outcomes where the material facts (specifically the functions performed) are the same, we believe it is crucial for the OECD to recognize and address the similarities in the transfer pricing analysis under article 7 and article 9 of the Model Tax Convention, specifically the functional analysis as part of the prescribed comparability analysis. Since the Guidelines apply by analogy to determine the attribution of profit to a PE under article 7, the proposal in the Discussion Draft creates significant uncertainty for financial institutions without such consideration. We recognize that there are differences between operating through a PE and subsidiary, however these do not impact the functional analysis stage of the transfer pricing analysis. Therefore it is of crucial importance to:

1. use consistent approaches and terminology when describing and qualifying certain people functions as key indicators of value creation in the PE Report and the Guidelines; and
2. develop one set of criteria for the recognition of accurately delineated transactions and the recognition of dealings.

The CBA believes it is of crucial importance to revisit the proposed changes to Chapter I of the Guidelines and ensure consistency with the approach and terminology used in the PE Report.

2) Introduction of additional terms involving subjective judgment

The Discussion draft introduces the use of new terms and continues to use terms currently used in the Guidelines such as options realistically available, moral hazard, commercial rationality, opportunities realistically available, the commercial reality of independent parties etc.

If one assumes that objective information is available in the public domain to inform how these terms apply to the specific facts and circumstances of an MNE, the approach in the Discussion Draft could work. However, the reality is that objective information is not available in most cases. This then introduces the subjective judgment of MNE’s and tax administrations to generate a vast universe of positions that will likely not align in a significant number of cases. The resulting controversy and uncertainty do not benefit tax administrations and MNE’s and will lead to additional cost for both.
With respect to moral hazard it is our view that, due to the fact that there is common control within an MNE, the related parties are unlikely to act contrary to interest of one another, with the result that moral hazard does not arise. Therefore it is our view that under the arm’s length principle moral hazard should not play a role when determining the allocation of risk between related parties.

We strongly suggest that the OECD revisits the appropriateness of terms in the Discussion Draft that foster subjective interpretation and attempts to find more objective ways to address BEPS through its changes to the Guidelines.

3) Assumption of BEPS behavior without consideration of restrictions imposed by the regulatory environment

While the Discussion Draft repeats the language from the current Guidelines with respect to using the written agreements between related parties as the starting point for the transfer pricing analysis, the proposed changes indicate a strong focus on the conduct of the parties as the basis for recognizing the transaction for tax purposes. For financial institutions, the regulatory environment often restricts the number of ways in which an intercompany transaction can be structured. Therefore the contractual arrangements put in place and conduct of the parties in certain circumstances can lead to different interpretations by financial institutions and tax administrations and result in controversy. A specific example is the situation where personnel of a broker-dealer legal entity books trades on the books of the permanent establishment of the parent company in the same country because of regulatory reasons and capital requirements.

The CBA encourages the OECD to clarify the application of the Guidelines to regulated entities, as non-recognition of a related party transaction entered into specifically to satisfy regulatory requirements and without a BEPS motive, can lead to significant adverse consequences for an MNE, such as required capital injections, losing banking or trading licenses and regulatory fines.

We kindly thank you for considering our comments and would welcome the opportunity to elaborate on our comments during the public consultation on March 19 - 20, 2015.

Sincerely,

[Signature]
CBI RESPONSE TO THE OECD PUBLIC DISCUSSION DRAFT ON BEPS ACTIONS 8-10: REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERISATION AND SPECIAL MEASURES)

1. The CBI is pleased to comment on the OECD’s Public Discussion Draft on Actions 8-10: Revisions to Chapter I of the transfer pricing guidelines (including risk, recharacterisation and special measures).

2. As the UK’s leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

3. The CBI continues to support the BEPS programme to update international tax rules to reflect modern business practice, tackle abusive tax structures and target the incidence of double non-taxation. However, we are concerned that if complexity and uncertainty are not avoided, the outcome will be an increase of double taxation and resulting legal disputes, which could have a substantial and negative impact on cross border trade and investment, but also on tax administrations with limited resources.

Overview

4. The CBI welcomes and would support the general approach to the update of Chapter 1 of the transfer pricing guidelines.

5. We agree with the methodology set out in Section D1 of the paper as it generally reflects current best practice for MNEs in applying an analytical approach to implement their own transfer pricing policies.

6. Whilst we welcome the attempt in paragraphs 40-42 to provide a framework for transfer pricing risk, we are concerned that as drafted, taxpayers would be required to perform this analysis in respect of every transaction (as nearly all commercial transactions involve some element of risk). Such detail would be difficult in many cases to supply, and would prove a very onerous burden on compliance. We would recommend that much clearer guidance is required as to when such an analysis is required (such as materiality or gateway type tests).

7. The current discussion of risk is not directly relevant to a number of Financial Services Activities. Part’s II, III and IV of the OECD's guidance on the attribution of profits to permanent establishments provides detailed and comprehensive guidance on risk in banks, financial markets and insurance companies. The guidance was the outcome of significant consultation with industry and therefore we consider that for these industries, considerations for risk identification should be linked to this existing guidance.
Accordingly, we believe the OECD’s current work should acknowledge the 2010 Report remains the relevant approach for financial services.

8. Whilst we welcome the wording in paragraph 82, it would be helpful if this was strengthened to make it clear that non-recognition could only be used as a last resort. Specific emphasis needs to be placed on the words “Importantly, the mere fact that the transactions may not have been seen between independent parties, does not mean that it does not have characteristics of an arm’s length arrangement”. We would recommend that where a tax treaty is applicable, non-recognition should only be possible once a preliminary MAP/treaty discussion with the corresponding tax authority has taken place to ensure any double taxation can be resolved under the MAP process.

9. To the extent that special measures are required after the amendments to Chapter 1, it should be made clear that the normal arm’s length rule should be applied first, with special measures then only applying to a clear defined range of circumstances that the arm’s length principle is considered inadequate. Special measures should not be used as a short cut or substitute for an arm’s length analysis.

10. Further detailed work is required before a real judgement can be made on the special measures identified. For option 1, the key point needs to be the criteria to be met in respect of documentation and how future developments and external events can be catered for. With regard to the options for the inappropriate returns to providing capital, based on the limited information, Option 4 may be preferable if refined. It is unclear how options 2 and 3 would work in value chains involving a large number of entities and Option 5 appears to be targeting purely low tax regimes and not substance, and therefore should be left until the work on BEPS Action 3 is complete.

Detailed Comments

11. The CBI has reviewed the response prepared by BIAC. The BIAC response provides a detailed analysis in respect of the proposals and the CBI supports the conclusions reached in that paper. We have however noted points of specific interest to British business, and where possible, provided further examples from our members.

D.1 Identifying the commercial or financial transaction

12. We welcome the approach in D1 which provides very clear guidance and principles to follow in order to analyse the transfer pricing on an arm’s length basis. In particular, the written statement in paragraph 3 which states that “where a contract exists, that is the starting point for delineating a transaction and that actual conduct should be reviewed in the context of this written agreement”. Therefore, unless noted below, we agree and fully support the proposed wording in section D.1.

13. In paragraph 6, in the example provided, P appears to be providing both a licence to S and providing services to S such that P is acting as agent to all or part of S’s business with third parties and using intellectual property licensed in that context. The example in paras 90-92 modified so that S2 is granting an exclusive licence to S1 may prove an example of the point intended to be illustrated in paragraph 6.

14. The references to the use of hindsight in paragraph 7 (and later in paragraph 89) is a significant departure from current pricing methodologies and that delineation should only take place to the extent that 3rd parties would have been likely to seek to renegotiate contract terms – i.e. the departure from the original agreed terms was sufficiently significant to renegotiate contracts.

15. We would recommend paragraph 18 is either amended to make it clear as to what is intended to be addressed, or the paragraph is deleted. We have reviewed and agree with the response of the Association of British Insurers (ABI) who have outlined and analysed this point in detail.
16. Paragraph 21 (and paragraphs 85-87) refer to the ability of MNE’s to fragment their activities in a way to achieve a transfer pricing advantage. There are many commercial reasons for fragmentation and many legal reasons why companies are not able to change the structure to a more centralised model. We are concerned that some tax authorities could take from the proposed wording of these paragraphs that all fragmentation is tax motivated. We therefore request the emphasis within these paragraphs is changed to focus on only abusive structures.

D.2 Identifying risks in commercial or financial relations

17. Almost all commercial transactions involve, to some degree, a transfer of risk. Whilst we can understand the justification of aligning the risk with how parties actually manage the risk, there are many commercial situations where this may be more difficult to determine. The proposed approach outlined in paragraphs 40-42 works on a transaction by transaction basis which will be difficult to comply with and a significant burden.

18. We therefore seek a practical approach to this through the introduction of an objective materiality or gateway threshold such that detailed analysis is only required on larger transactions. A number of other factors outlined in the BIAC response to this section also need to be taken into account.

Moral hazard

19. Whilst we accept there is a concept of moral hazard, there are plenty of safeguards within a group which ensure that in the majority of situations, the same criteria applies as to third party situations. It is also not always the case that third parties will accept risk only if they have safeguards in place. The insurance industry is a clear example of this.

20. Outlined below are some of the safeguards that exists such that companies within the same group do act independently and the moral hazard issue is therefore not in point:

- Management incentives based on entity results
- Fiduciary responsibilities of directors requiring the interests of the company are managed in priority to the group
- Joint venture arrangements and minority interests where part of the value could leave the group
- Different group companies independently tendering for the same public contract

Risk - return

21. As a starting point, all transfers of risk should be recognised. There are clear examples, e.g. insurance and various derivatives in the financial markets, where companies solely transfer the risk to an independent third party. Therefore unless clear thresholds have been reached which address abusive behaviour only, no transaction should be disregarded.

Financial Services

22. The current proposals outlined would not be sufficient to deal with regulated financial markets. Parts II, III and IV of the OECD’s guidance on the attribution of profits to permanent establishments provides detailed and comprehensive guidance on risk in banks, financial markets and insurance companies. The guidance was the outcome of significant consultation with industry and therefore we consider that for these industries, considerations for risk identification should be linked to this existing guidance. Accordingly, we believe the OECD’s current work should acknowledge the 2010 Report remains the relevant approach for financial services.
23. The ABI, British Bankers Association (BBA) and Association of Financial Markets in Europe (AFME) have prepared detailed responses to this question in respect of British financial services companies. We have read their responses and agree with the conclusions reached.

D.3 Interpretation

24. Whilst we welcome the wording in D3, it would be helpful if certain areas were strengthened. Certainty is a key factor for business in relationships with many external stakeholders (including tax authorities) and therefore the use of recharacterisation or special measures should only be used as a last resort.

25. In paragraph 82, we particularly welcome the words “Importantly, the mere fact that the transactions may not have been seen between independent parties, does not mean that it does not have characteristics of an arm’s length arrangement”. We request that much greater emphasis is given to this statement such that it is clear to tax authorities, the lack of comparables does not mean an arm’s length price cannot be determined.

D.4 Non-recognition

26. There are two key acknowledgements in paragraph 84. First of all, that non-recognition creates double taxation. Secondly, that the mere fact that the transaction may not be seen between independent parties does not mean it should not be recognised. It is vital therefore that clearly defined boundaries must be reached before non-recognition can be enforced by tax authorities. We recommend that a gateway test that outlines criteria that must all be satisfied before non-recognition can be enforced should be included in the guidance notes.

27. We would also request that such measures can only be enforced when the transaction is with a treaty partner once MAP procedures have been initiated. This should ensure agreement with treaty partners and reduce the scope for prolonged disputes.

Part II – Special Measures

28. Special measures should not be used as a short cut or substitute for a proper arm’s length analysis. To avoid this outcome it is essential that the use of special measures be clearly defined and only available to tax authorities once all conditions in a Gateway test have been met.

29. As for non-recognition, we would also request that a special measure can only be enforced when the transaction is with a treaty partner once MAP procedures have been initiated. This should ensure agreement with treaty partners and reduce the scope for prolonged disputes.

30. Further detail would be required before we can provide detailed comments on each of the proposals. However, we have outlined some initial thoughts on each one below:

   Option 1 – Hard to Value Intangibles

31. It is our view that the use of earn-out clauses in commercial deals relating to the transfer of intangibles is overstated. There is little evidence to support this as in the significant majority of third party transactions, a seller would be looking to divest all future risk, whilst a purchaser would normally be looking for the reward of taking on the full risk of the asset.

32. The limited circumstances in which earn-out clauses are used in practice include a compromise to bridge valuation gaps in order to allow a transaction to proceed, or to ensure that a seller that will remain engaged in the business post sale is incentivised to perform.

33. It is unclear as to how post transaction revenues are to be measured given that in most cases, the intellectual property will be subject to continuous development and potential changes to the external
market which cannot be foreseen at the time of sale. New technologies may have a positive or negative impact. Significant global events may impact the economy. It is unlikely that assumptions made in modelling future returns at the time of the sale will all be relevant place post sale.

34. The key issue outlined in the scope to this option is that this measure should only apply where the taxpayer does not contemporaneously document those projections and make them available to the tax authorities. This definition needs expanding with detailed guidance on what is reasonable for companies to assume and the level of detail for the forecasts in order to provide certainty. Taxpayers wishing to minimise the risk of the special measure will want to follow appropriate safeguards and guidance is required in order for this to work in practice. This is essential to minimise those circumstances where there will be asymmetry for both the taxpayer and the other affected tax authority, where an adjustment is only ever proposed by the tax authority that would benefit from an increase in the hard to value intangible. A rule, with a much narrower and more objective scope may be more appropriate if it targets solely situations where the consideration has been deliberately manipulated for tax purposes.

Option 2 – Independent Investor

35. It is unclear how this option will work for more complex value chains. The example assumes that there will always be a single company which the asset rich company depends on for its return. In many MNE structures, there will always be multiple companies.

36. Further guidance will also be required as to what steps should be undertaken to determine what option an independent investor would take if there were multiple options available.

37. Any special measure should have an element of certainty to enable taxpayers and tax authorities to come to an agreed position. It is unclear that this measure will achieve this objective, and in many instances, the uncertainties will be detrimental to achieving it. Even in the simple case described in the paper, it is not clear that an independent investor would choose one company over the other.

Option 3 – Thick Capitalisation

38. The starting point to this measure seems to be an arbitrary ratio. It is unclear whether this test would also be applied to all group companies, or just specific ones. Different groups in different industries will have significantly different capital ratios. Even within a group of companies, different entities will naturally need a different level of capital. Asset rich companies are likely to have greater leverage compared to service entities within the same group of companies.

39. There are many commercial obstacles to companies managing the leverage ratio to ensure that they fall within line with a group ratio. Issues such as exchange controls, distributable reserves, covenants etc will mean that companies cannot change the capital structure. The issues in this action are similar to those in the proposal for a group wide interest allocation system in Action 4. Please refer to the CBI response to the discussion draft for Action 4, question 7 for further details of the commercial issues which mean companies cannot meet such requirements.

Option 4 – Minimal Function Entity

40. We note that this option is drafted more widely than to deal with the issue of the inappropriate return for providing capital.

41. If a minimal functional entity approach is to be adopted, then the wording should purely reflect the ability of the company to carry out its business. This will vary depending on the type of activity being
carried out. There are several international cases looking at tax residency which have confirmed that there does not need to be a lot of substance, just sufficient substance. For example, it may only require a small number of people to manage the financial risk of a treasury company. However, more people would be required in a labour intensive contract manufacturing process.

42. Focusing on the ability of a company to perform its duties would be a key requirement to making the rules EU law compliant (following the Cadbury’s Schweppes case). If insufficient functional capacity is not present, then reallocation or other adjustment may be appropriate – however the outcome of such a measure would need to be clearly defined and predictable to both tax payers and tax authorities.

43. In any case it seems likely that the other BEPS actions, such as on CFC rules, will address any concern that is not resolved by the general approach set out in the draft of Section D in first part of the discussion draft.

Option 5 – Excess Returns

44. This proposal is triggered based on a test which refers to a low rate of tax. As outlined in other BEPS Action plans (e.g. Action 2 – hybrid mismatches), tax rate competition is not considered to be a focus for the BEPS Action Plan as this is a sovereign right for countries to determine. This type of measure will only be appropriate once consideration is given to the sufficiency of functions in that entity, otherwise it is inconceivable as to how this can be made EU law compliant.

45. There would be further clarification needed on what an “excess return” is, and we do not consider, as implied in the discussion draft, that all related party service provisions should be treated as objectionable.

46. Whilst CFC rules may be appropriate in dealing with some of these issues, it cannot be in the crude form outlined in this option. We would recommend waiting for the conclusion of Action 3 on CFC rules to determine whether the outcome of that action already addresses the risks this option is targeting.

47. We trust that you will find the above comments helpful in understanding the potential impact of the proposals outlined in your paper. We remain committed to ensuring that each BEPS Action achieves its stated goals, whilst ensuring that genuine business arrangements are not unduly impacted to which this Action forms a key part.

48. We remain at your disposal should you wish to discuss the issues we have raised in this paper in more detail. Please contact neil.anthony@cbi.org.uk for more information.
1 Introduction

1.1 The Chartered Institute of Taxation (CIOT) is pleased to respond to the public discussion draft published by the OECD in December 2014 entitled BEPS Actions 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation and special measures).

1.2 We support the aims of the OECD to ensure that transfer pricing outcomes are in line with the economic substance of a transaction including, in particular, value creation. However, we have some general comments regarding the approach being suggested.

2 Part I - revised Section D of Chapter I of the Transfer Pricing Guidelines

2.1 In general the revised Section D of Chapter I of the Transfer Pricing Guidelines (Section D) set out in Part I of the discussion draft does a good job of identifying the circumstances in which to look beyond the contractual documentation in order to determine the appropriate treatment for transfer pricing purposes.

2.2 However, we do have concerns around the circumstances in which it is suggested that an entity, which has a separate legal personality, can be overlooked/ignored. This concept is principally discussed at section D.4. Non-recognition.

2.3 We suggest that the concept of an entity having a separate legal personality is a fundamental legal concept and that the ability of a legal person to contract and take on risk and be rewarded is fundamental to the international trading system.
2.4 There are fundamental legal concepts which mean that ultimately a legal person is responsible for its actions, and that person should not be ignored, except in very limited circumstances. Unless the multinational group is acting in such a way as to deprive the entity of all its responsibilities, the entity must be left with *something* and must bring *something* to the transaction – and that something must have a value – even if that value is very small.

2.5 We suggest that unless it can be shown that the involvement of a particular legal entity is, in effect, a deliberate or inadvertent sham – by which we mean that the existence and involvement of the legal entity means absolutely nothing in relation to the transaction, such that it could be removed altogether with no effect, then there must be *something* that the legal entity is doing, and this will have a value – albeit small in some cases.

2.6 We think that there should be great caution exercised before suggesting that legal entities should be ignored on the basis that they have no purpose in a particular transaction, as to do so undermines the fundamental legal concept of separate legal personality.

3 Part II – Potential Special Measures

3.1 We recognise the perceived need for special measures, but would emphasise that, as noted in paragraph 2 of Part II, the proposed revisions to Section D set out in Part I will address most areas of concern.

3.2 We would like to seek assurance from the OECD, and suggest that it should be made clear in any special measures which are adopted, that special measures are intended to be a back up to the guidance in Section D. We would be concerned if tax authorities were to invoke special measures too readily.

3.3 If amended as proposed, Section D will be very comprehensive and should apply to the vast majority of transactions. However, inevitably, applying Section D to complex transactions will involve some hard work on the part of taxpayers and tax authorities. However, to seek to do so in the first instance should clearly be stated to be the correct approach. Applying Section D is the best way to ensure that the transfer pricing outcomes are in line with economic substance; special measures would always be more of an approximation.

3.4 Thus we suggest that special measures should be viewed as a last resort. To mitigate the danger of special measure become a bench mark or default position for tax authorities, it should be clearly stated that any measures emerging from Part II of the discussion draft should only be invoked following a good faith negotiation between the taxpayer and tax authority regarding the application of Section D.

4 The Chartered Institute of Taxation

4.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT’s work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax
Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members’ experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT’s comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT’s 17,000 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’, to represent the leading tax qualification.

The Chartered Institute of Taxation
3 February 2015
January 23, 2015

Andrew Hickman,
Head of Transfer Pricing Unit,
Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
2 Rue André Pascal
75775 Paris Cedex 16
France

Via e-mail to transferPricing@oecd.org

Dear Mr. Hickman:

Re: OECD Base Erosion and Profit Shifting (“BEPS”) - Action Plan 8, 9 &10

The Canadian Life and Health Insurance Association (“CLHIA”) is pleased to provide comments on behalf of its member companies on the Discussion Draft on Revisions to Transfer Pricing Guidelines (Risk, Recategorization and Special Measures) (the “Discussion Draft”) that was released in December, 2014 by the OECD.

The CLHIA is the national trade association for life and health insurers in Canada. Our member companies account for 99 per cent of Canada’s life and health insurance business and provide a wide range of financial security products. Canadian life insurers also operate in over 20 countries around the world and three of our members rank among the top 15 global life insurers by market capitalization. A quarter of the CLHIA’s members operate as subsidiaries or branches of foreign insurers or reinsurers from the United States and Europe. The CLHIA is also a member of the Global Federation of Insurance Associations (GFIA) based in Brussels.

The CLHIA supports the G20’s and the OECD’s initiative to prevent base erosion, including the review of Transfer Pricing Guidelines above. However, our concern over the cumulative effect of BEPS on business operations of multi-national enterprises (MNEs) is growing with release of each discussion draft on the various action plans. The scope of each of these initiatives will give rise to complexity, uncertainty and incremental cost. The resulting negative impact on global trade and investment, far outweighing any potential tax revenues, is counter to the OECD’s mission to promote economic growth around the world. We urge that the final measures taken by the BEPS initiative be proportionate and balanced.
Isolating and identifying risks including "moral hazard", "risk-return trade-off", etc. are all relevant considerations in ensuring transfer pricing outcomes are in line with value creation. However, the concepts and concerns around risk associated with general business transactions are fundamentally different from where the core business itself is accepting third-party risks.

As the Discussion Draft accurately notes, assuming and managing risks is the insurance industry's stock in trade. Insurance is the transfer of risk from the insured to the insurer or reinsurer. Unlike other industries, insurers take on risk in relation to which they have virtually no control. Rather than controlling the risk, the focus here is determining an appropriate price to be charged for the type and level of risk assumed (insurance premium) taking into account the inherent uncertainties relating to the risk insured (the expected and unexpected) and the cost of capital to support that risk. Insurers then seek to pool and diversify this risk by writing additional business on uncorrelated risks via third party and/or affiliate reinsurance.

Affiliate reinsurance is a response to the problem of moral hazard as well as adverse selection. In a third party transaction, the insurer often knows more than the reinsurer about the risks it insures, and this information asymmetry may create an incentive for the insurer to transfer the worst risks and/or be less diligent in its underwriting. If the insurer and reinsurer are part of the same corporate group, their incentives are aligned. The decision to assume risks would exclude “moral hazard” considerations and focus on the capital required and their existing risk portfolios.

Therefore, the direct application of some these concepts to the financial services sector are not appropriate, especially in the insurance sector. Accordingly, we do not consider that the general comments as set out in the discussion draft can or should apply to the insurance industry.

Perhaps recognizing this concern, the Discussion Draft poses a specific question to the financial services sector (at p. 15): “Is the discussion of risk of a general nature such that the concepts apply to financial activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?”

The general nature of comments in the Discussion Draft will add confusion in the context of insurance or reinsurance transactions. The OECD's *Report on the Attribution of Profits to Permanent Establishments Part IV (insurance)* ("Part IV") includes comprehensive guidance defining and discussing risks, risk management and allocation of risk in the context of insurance businesses. It elaborates on the parts of the value chain which should be enumerated, including capital requirements for assuming and managing all aspects of risk (insurance, investment, operational and other). Therefore an unambiguous carve-out from the general considerations in this Discussion Draft and a specific provision referencing the relevant existing guidance for the insurance industry within Part IV would be appropriate.

Much of the Discussion Draft's efforts in terms of identifying and allocating the impacts of risks are not relevant for the insurance industry given the highly regulated and transparent nature of transfer of risks in this industry, both in terms prudential regulations as well as specific accounting requirements already in place (local and international). For example, there are detailed requirements to recognize, measure and present risks inherent in insurance contracts in financial statements (based on economic substance as opposed to legal form). In addition there are significant disclosure requirements with regards to the insured risks and sensitivities (insurance, investment, operational and other).
The following are some examples of comments in the Discussion Draft that are not relevant to the insurance business model, given the regulated environment under which it operates:

Paragraph 38 notes, "it is difficult for the party assuming risk to evaluate the required additional expected return when the factors affecting the risk outcomes are determined by another party". It goes on to add, in view of the moral hazard considerations, that parties should be allocated a greater share of those risks over which they have relatively more control. This does not hold true to those accepting and managing risks as a business.

Again the final sentence of paragraph 78, "A party which does not control risk will not be allocated the risk and therefore will not be entitled to unanticipated profits" is also inconsistent with the basic premise of insurance and reinsurance contracts. As noted earlier, the inability of insurers to control risks of the insured and any moral hazard considerations are dealt with through pricing of contracts and insurers have controls in place to minimize pricing and other risks. The motivation for insurers is not to drive behavior but to understand the risk insured and price for those risks including a margin.

Paragraph 67 notes that “Third parties may be unlikely to provide insurance for core competencies unless they have significant information about and control of potential outcomes due to moral hazard that the incentive to manage risk by the insured party is lowered.” Insurers routinely provide insurance coverage for various risks on which they will not have direct core competency. Their core competencies relate to experience in underwriting such risks (internal as well as available market experience and data). The price or premium charged will reflect the expected losses based on the experience as well as a margin for the uncertainties associated with that risk.

While the Discussion Draft draws attention to the fact considerations may differ for regulated business (for example para. 66 "MNE groups, unless subject to capital adequacy regulations, can determine the capital structure of subsidiaries without explicit consideration of actual risk in that subsidiary"), it is important to be unambiguous on the inapplicability of these general guidelines to insurers. As such, only a full carve-out for regulated insurers from these general guidelines will avoid any unintended consequences on the insurance industry. Many of the concepts and comments in this Discussion Draft would cloud the analysis and hence the outcome on transfer pricing.

Unintended consequences such as over capitalization for the insurance group (through lack of diversification opportunities) and or excessive taxation, would likely lead to market inefficiencies. One of the key tools for managing risks is through risk diversification, reducing the concentration of one type of risk by underwriting many different types of risks. Diversification of risk can be achieved by writing business in different geographical locations (e.g. earthquakes in Japan versus Wind/Winter storm in Europe), or by underwriting products with naturally offsetting risks (mortality and longevity risks). These diversification benefits are achieved through reinsurance, both external and inter-affiliate reinsurance. Diversification through reinsurance plays an integral role in managing cost of capital by insurers and reinsurers. These efficiencies flow through to the insured/customer in terms of reduced pricing of insurance protection.

Therefore it is critical that the transfer pricing guidelines take into consideration the important and unique aspects of global risk diversification to the insurance sector and limit any broad brush approaches to BEPS that would undermine the genuine substance of reinsurance transactions.
Part II – Potential Special Measures

We are concerned over any move by the OECD to step away from the arm’s length principle to maximize tax revenues in the interest of preventing BEPS. We believe such overreach is counter to OECD’s overall mission re global trade.

Inappropriate Returns for Providing Capital

CLHIA is of the view that the Special Measures as currently drafted impose arbitrary criteria to alter capital and profit allocation between companies. This has the potential to ignore transactional relationships between separate entities to recharacterize income or expenses in order to maximize tax revenues.

For example, applying the concept of "thick capitalization" for insurance groups that operate within very specific regulatory constraints would be highly inappropriate. The key area of focus for regulators is the amount and type of capital required to manage existing risk and for continued business activity and viability. While there are minimum and target capital requirements by multiple regulators (local vs group or consolidated requirements), the optimum capital for an insurance group can be more nuanced due to capital market requirements (ratings agencies and analysts). Prudential regulators recognize the necessity and economic substance of affiliate insurance/reinsurance transactions by not requiring each affiliate to hold capital on a stand-alone basis, but on a basis that reflects the risks transferred and retained between the affiliates.

Prudential regulators also impose quality of capital requirements on insurers; focus is on higher loss absorbing forms of capital, such as equity capital, and strict limits on debt capital. Because of this highly regulated and restrictive environment, it would be wholly inappropriate to impose any form of pre-determined capital ratio to allocate or shift profits between entities and jurisdictions.

The scope of any "minimal functional entity" option is also a cause for concern. While this option proposes qualitative and quantitative thresholds to determine functionality, a simple application of these attributes may give rise to profit reallocation that may be entirely at odds with risks and rewards within the reinsurance industry. The business models of direct insurer, reinsurer and retrocessionaire illustrate how functionality decreases as risks are transferred along the chain. Reinsurers and retrocessionaires (insurers of reinsurers) require few people to assume the risks but this does not mean that their return should be limited.

We urge the OECD to clearly and unequivocally exempt the insurance industry, and the reinsurance industry in particular, from such targeted special measures.

Yours Sincerely

Noeline Simon
Vice President, Taxation and Industry Analytics
Revisions to Transfer Pricing Guidelines (Including Risk, Re-Characterization and Special Measures) – Concerns and Recommendations

A REPRESENTATION
Contents

Background ................................................................................................................................................... 2
Non- recognition and Re- characterization of actual transactions............................................................... 2
“Value creation” and “Options realistically available” .................................................................................. 3
Special Measures .......................................................................................................................................... 4
Hard to value intangibles – Actual vs projections.................................................................................... 4
BEPS: Action 8, 9 and 10 – Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Re-Characterization and Special Measures) – Concerns and Recommendations

Background

On December 16, 2014, the OECD issued a Discussion Draft on revision to Chapter I of the OECD Guidelines providing emphasis on determining the functions, asset and risk (FAR) profile of associated enterprises (AEs) by focusing on the economic circumstances of the commercial and financial relations between the AEs and on determining the parties managing and controlling risks through conduct of parties instead of contractual allocation of risks between the parties. The Draft also provides guidance on the non-recognition or re-characterization of the actual transaction if the transaction does not possess fundamental attributes of an arrangement between unrelated parties.

The Discussion Draft also provides various options for Special Measures that may be adopted as a simple short cut to achieve a particular allocation of profit. However, the Discussion Draft does not contain specific language implementing those options but request comments on such options.

In general, we recognize the efforts of G20 along with the OECD towards providing guidance on FAR analysis, risk allocation and re-characterisation as well as transfer pricing under Special Measures. However, in view of the existing Indian tax system and the legal and economic environment in India, we foresee certain practical challenges in the implementation of the recommendations of the Discussion Draft in its present form for companies operating in India.

We wish to highlight some of the possible practical challenges and humbly put forth our recommendations for your kind consideration.

Non-recognition and Re-characterization of actual transactions

Concerns

The discussion draft proposes that a transaction between AEs should have the “fundamental economic attributes of arrangements between unrelated parties” else, the tax authorities may resort to non-recognition or re-characterisation of such transaction. However, the term “fundamental economic attributes” has not been defined by the Discussion Draft. This term is very subjective and may result in multiple interpretations by tax administration for resorting to re-characterization of transaction between AEs. It is a likelihood that this new approach of re-characterization/ non recognition of actual
transaction which is being blessed by OECD may accentuate the tax controversy and disputes as the tax authorities would more and more tend to re-characterise intra group transactions on some or the other basis and would proceed with re-allocation of larger profits in their jurisdiction. The tax authorities would challenge the transfer pricing documentation and could also impose documentation and other penalties.

The tax authorities may take recourse to re-characterisation of transactions based on limited information/ non-consideration of the overall arrangement between the AEs or may not consider the economic rational and the indirect or incidental benefit to taxpayer from a particular transaction. Re-characterization also impacts the taxation of other transacting AEs as it modifies the original transactions which would have been presented/disclosed in the other jurisdiction(s) of the transacting AEs leading to double taxation.

**Recommendations**

- It is recommended that a strict interpretation and detailed guidance with examples may be provided in relation to “fundamental economic attributes” as it has been considered as the basis for non-recognition or re-characterisation of a particular transactions between AEs of an MNE.

- Use of such a subjective term would create uncertainty, controversy and would have far reaching impact on intra group transactions and structures of MNEs. The OECD should emphasize that re-characterisation should be adopted in only exceptional circumstances and should provide detailed guidance (including examples relating to such exceptional circumstances).

- Since, the re-characterisation also impacts the taxation of the other transacting AEs and may lead to double taxation, it would be appropriate to build in the mechanism of bilateral/multilateral dialogue and consensus within the tax authorities/competent authorities of the transacting jurisdictions in case of any proposed re-characterization by the taxing authority, so as to ensure consistency of nature of transaction in both/ all transacting jurisdictions and avoid any potential double taxation.

“Value creation” and “Options realistically available”

**Concerns**

The discussion draft lays emphasis on ‘value creation’ and examination of ‘options realistically available” in identifying the commercial and financial relations between the AEs. Both the terms are subjective and are susceptible to multiple interpretation and consequential controversies. What is to be construed as value is open to interpretation. It could be sales, revenue, income, profits, competitive advantage,
synergies, economic power, asset ownership or any other measure. Similarly, when can an alternative be considered realistic is ambiguous. Whether parties are required to review all possible permutations and combinations and are required to choose transaction that maximizes the quantum of tax in a particular jurisdiction under this criterion of “options realistically available” needs to be clarified. This could also lead to unnecessary burden of excess documentation requirement on part of the entities.

**Recommendations**

The Discussion Draft may consider providing concrete and detailed definition or guidance of both these terms to avoid arbitrary application and aggressive interpretations by the tax authorities.

**Special Measures**

**Concerns**

The need for providing special measures in the Discussion Draft beyond the arm’s length principle needs to be reviewed. Particularly since these proposed special measures deal with various aspects which have been covered by other action plans and therefore, may not be required in light of the work carried out under other actions. Such special measures in a way recommend the use of global formulatory approach, which is not the objective of the present draft.

**Recommendations**

It is recommended that the OECD re- considers the inclusion of the proposed special measure and if required, restrict the alternative measures within the arm’s length principle only. Further, it is also recommended that the OECD suggest specific structure/circumstances which are targeted to be addressed by such special measures.

**Hard to value intangibles – Actual vs projections**

**Concerns**

The Discussion draft envisions the challenges in determining the arm length pricing of hard to value intangible due to availability of lack of comparables, use of several assumptions that may be speculative and may not be verifiable. The Discussion Draft suggests that in such circumstances, the taxpayers may fix a lump sum price or fixed royalty rate based on projections and the tax administrations could verify such projections based valuations from actual outcomes and may make price adjustments. However, generally, the tax authorities do not consider projections for the purpose of determining arm’s length
pricing. The tax administrations generally try to adopt their own methodology for imputing arm’s length valuation in such cases and even disregard the valuation undertaken by an independent valuer through a scientific approach.

**Recommendations**

- It is important that OECD emphasizes the acceptability and use of independent third party valuation certificates by the tax authorities. Valuation is a specialized technique and therefore, reliance should be placed on the exercise performed by the independent valuer. Discarding the use of the valuation undertaken by independent parties should only be considered as an exceptional measure and should only be undertaken in special scenarios. Further, in case of disregarding the valuation certificate, the tax authorities should also be advised to get the valuation done from an independent valuer rather than doing the valuation in-house.

- The returns for intangibles are not always owing to the original form of the intangibles. In many cases, the enhanced return from the intangible may be owing to the contribution made by the buyer in enhancing the value post the acquisition and not alone due to the intangible transferred in its original form. In such a scenario, a simple comparison of the actual result vis-a-vis the projections may not be appropriate and guidance on this aspect should be provided by OECD.
The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government, and civil society, through advisory and consultative processes.

CII is a non-government, not-for-profit, industry-led and industry-managed organization, playing a proactive role in India’s development process. Founded in 1895, India’s premier business association has over 7200 members, from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 100,000 enterprises from around 242 national and regional sectoral industry bodies.

CII charts change by working closely with Government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialized services and strategic global linkages. It also provides a platform for consensus-building and networking on key issues.

Extending its agenda beyond business, CII assists industry to identify and execute corporate citizenship programmes. Partnerships with civil society organizations carry forward corporate initiatives for integrated and inclusive development across diverse domains including affirmative action, healthcare, education, livelihood, diversity management, skill development, empowerment of women, and water, to name a few.

The CII theme of ‘Accelerating Growth, Creating Employment’ for 2014-15 aims to strengthen a growth process that meets the aspirations of today’s India. During the year, CII will specially focus on economic growth, education, skill development, manufacturing, investments, ease of doing business, export competitiveness, legal and regulatory architecture, labour law reforms and entrepreneurship as growth enablers.

With 64 offices, including 9 Centres of Excellence, in India, and 7 overseas offices in Australia, China, Egypt, France, Singapore, UK, and USA, as well as institutional partnerships with 312 counterpart organizations in 106 countries, CII serves as a reference point for Indian industry and the international business community.

Confederation of Indian Industry
The Mantosh Sondhi Centre
23, Institutional Area, Lodi Road, New Delhi – 110 003 (India)
T: 91 11 45771000 / 24629994-7 • F: 91 11 24626149
E: info@cii.in • W: www.cii.in

Follow us on:
facebook.com/followcii twitter.com/followcii
www.mycii.in

Membership Helpline: 00-91-11-435 46244 / 00-91-99104 46244
CII Helpline Toll free No: 1800-103-1244
Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris  
France

Submitted by email: TransferPricing@oecd.org

Confederation of Swedish Enterprise - Comments on the OECD Public Discussion Draft entitled: "BEPS Action 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk Recharacterisation, and Special Measures)" 1 December 2014 - 6 February 2015

The Confederation of Swedish Enterprise is Sweden’s largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled "BEPS Action 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk Recharacterisation, and Special Measures)" 1 December 2014 - 6 February 2015 (hereinafter referred to as the Draft).

General Comments

The Confederation of Swedish Enterprise appreciates the efforts by the OECD to develop recommendations regarding revisions to chapter I of the Transfer Pricing Guidelines (the Guidelines).

The Draft is divided into two parts. The first part contains a revision to section D of Chapter I of the Guidelines and the second part contains options for some special measures. As set forth in the Draft, the aim of Actions 8-10 of the BEPS project is to assure that transfer pricing outcomes are in line with value creation. We support the aim of actions 8-10 and believe that if carefully drafted, it could satisfy the need to prevent BEPS as well as provide additional guidance and predictability for companies.
However, in our view the Draft does not deliver sufficiently on the above-mentioned objectives. We find that several of the new requirements outlined in Part 1 of the discussion draft are too ambiguous and onerous to be manageable. In particular, the principles set out in section D.2. seem to require risk identification and valuation at a level of detail which would be very difficult to comply with in practice. The Draft requires a substantially more detailed risk analysis than under current guidance, with more areas and analyses for MNEs to cover in their transfer pricing documentation. By way of example, bench-marking data is typically not available at the level of detail required to conduct the exhaustive risk analysis required throughout the document. We are therefore concerned that taxpayers despite their best intentions and efforts will fail or be seen to fail to comply with these new standards with an increased risk of double taxation, disputes and/or recharacterisation as a consequence.

In addition, while the guidance in the Draft may provide more information for MNEs to consider when pricing their internal transactions, it also provides tax authorities with many ways to challenge and scrutinize MNEs’ transfer pricing policies, even when they have made a good-faith effort to be compliant.

The examples given in section D1 covers not just situations where contractual terms are ambiguous, incorrect or incomplete, but also genuine commercial transactions that are already in compliance with the Guidelines. This may lead some tax authorities to challenge and scrutinize transfer pricing policies, even in a situation where the transaction at hand is a genuine business transaction. In order to provide greater clarity, and to shift focus from genuine commercial transactions to transactions that are not in compliance with the Guidelines, we encourage the OECD to propose alternative examples.

Additionally, although we support the ambition to assist taxpayers and tax authorities in the implementation and follow up of transfer pricing models and policies by including examples, we think that the examples provided throughout the document are generally too simplified and frequently fail to identify several important aspects in commercial transactions (see further below). If the examples are to be kept, The Confederation of Swedish Enterprise believes that the Draft should clearly underline that they are included for illustrative purposes only and that they frequently are not applicable to related transactions. Otherwise, the measures and examples proposed might create misunderstandings and disputes.

The Draft also fails to address sufficiently the obstacle to find comparables to intra-group transactions. Risk management within an MNE is not equivalent to that between unrelated parties. Consequently, finding a comparable to a transaction between related parties will be very difficult. This will mean added uncertainty for MNEs that in good-faith try to comply with the transfer pricing rules.

Special measures, as suggested in Part II, create additional uncertainty for taxpayers. The Confederation of Swedish Enterprise believes that the analysis of
commercial and financial relations, together with (if necessary) the application of non-recognition rules, should be enough to guarantee a proper remuneration of the intragroup transactions within MNEs. For these reasons, we find no need for these special measures in order to avoid BEPS behaviors.

However, if they are to exist there must be a clear and consistently applied set of criteria for their application. It should be clearly expressed that they should apply only in exceptional cases. They also need to be applied consistently by all tax administrations in order to avoid an increase of tax disputes and potential double taxation.

Out of the suggested alternatives, we believe that option 5 is the most reasonable one. Appropriately designed CFC-rules have the potential to mitigate important BEPS behavior. It is important however that there is universal agreement on what is considered as an unacceptable tax level (and hence when CFC-taxation should be triggered).

Although all options presented in the paper are still very sketchy and unclear, the Confederation of Swedish Enterprise does not support any of the other alternatives mentioned in the paper. The principles outlined in options 2, 3 and 4 seems to be based on rather extreme concepts and we fail to see how they could be developed into something which is sufficiently predictable, not overly onerous and which will not hamper genuine business activities. As for option 1, we see a risk that it may open up for arbitrary use of hindsight. A better approach in our view is to include general guidance on the use of adjustment clauses recommending that such instruments should be used when it can be expected in third party situations and also outlining some guidance on how such clauses typically are designed.

Specific Comments

Part I – Revision of Chapter I of the Guidelines

D1 Identifying the commercial or financial relations

It is essential for taxpayers to have as much certainty as possible regarding legal agreement they have entered into. Consequently, we welcome the statement in paragraph 3 that where a transaction has been formalized by the taxpayer through written contractual agreement, that contract should provide the starting point for delineating the transaction and how the responsibilities, risk and benefits are to be divided. Only if the contractual terms are ambiguous, incorrect or incomplete should they be clarified or supplemented by tax authorities based on the actual conduct of the parties.
We do welcome that examples are included in section D1 of the Draft as examples help to assist MNEs in the implementation of transfer pricing policies and tax authorities auditing these policies. Unfortunately the proposed examples reflect common commercial situations and give little clarification of complex business transactions where the transfer pricing is not as straightforward. There is therefore a need for alternative examples which would help to more clearly illustrate the need to supplement or clarify contractual terms.

In paragraph 5 it is stated that “it should not automatically be assumed that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties”. We believe that this paragraph needs to be redrafted. We encourage the OECD to acknowledge that the starting point should always be that the contractual terms do reflect the actual relations between the parties. To keep the language as proposed would give tax authorities the possibility to challenge almost any contractual agreement, no matter how small the identified divergent they might have found.

Paragraph 7 sets out to deal with transactions which the taxpayer has failed to identify. Although there could obviously be situations where a taxpayer deliberately or by mistake has completely failed to recognize or take into account transactions that represent significant values, once again it needs to be emphasized that the great majority of taxpayers are devoting significant resources to making sure that all relevant transactions are identified and adequately described.

Commercial and financial relations between associated enterprises may however sometimes be very complex, just as they may be between independent enterprises. It is crucial that tax administrations do not immediately jump to the conclusion that there are transactions which the taxpayer has failed to recognize or account for. A rather comprehensive understanding of the entire business of the taxpayer may very well be required to ensure that this “deemed transaction” is not in fact included or bundled with some other transaction, the pricing of which does in fact take into account also this “deemed transaction”. Also in this context the Draft would benefit from some kind of materiality threshold indicating that great care needs to be taken before starting to construct transactions not identified or recognized by the taxpayer. As the immediate consequence in most cases will be double taxation, tax administrations should abstain from such measures unless there is an apparent error or mistake made by the taxpayer which has a significant impact on the results.

In paragraph 8 an example is provided that aims to illustrate a situation where taxpayers have not identified a transaction. In the example a subsidiary receive a service from a third party for which they appear not to be charged, either through reimbursement or through a service charge from the entity paying for the service. It should be acknowledge that the service charge could be taken into account in the pricing of another transaction between the parties, and thus that the lack of direct charge do not necessarily mean that the service is provided for free.
In paragraph 12 of the Draft it is stated that when independent enterprises evaluates the terms of a potential transaction they will compare the transaction to other options realistically available to them. Only when there is no alternative offering a better opportunity to meet their commercial objectives will the enterprise enter into the transaction. Although this might be true from a theoretical standpoint, it does however not take into account the time pressure and limited information that may be available when making a business decision. The different options are in many situations not as clear to the enterprise making the decisions as paragraph 12 indicates. There is a risk that the tax authority deems a result that could not have been foreseen at the time.

The requirements in paragraphs 12 and 89 to document different options available when making a business decision will no doubt make for an increased compliance burden for taxpayers. The documentation should cover the transaction undertaken, alternative options considered and the option not to undertake the transaction. Compared to the previous rules, the proposed revision requires more information on each transaction, and potentially also documentation on more transactions. To identify and document all this will demand extensive resources. Additional guidance regarding this issue would be welcomed to ensure that the documentation requirements are well-balanced and not excessive.

In addition to the examples provided in the Draft, it should be recognized that it is common for an agreement to be varied slightly without conducting a re-negotiation or amendment to the contract. This, however, does not mean that the contract is invalid. Tax Authorities should recognize that this can happen also between related parties without the need of significant supplementation or clarification.

D2 Identifying risks in commercial or financial relations

The Confederation of Swedish Enterprise shares the view that identifying risk is a critical part of transfer pricing analysis and agrees that this can give rise to difficulties. Therefore we welcome the intention of the Draft to give additional guidance and clarity regarding risk in section D.2.

However, identifying and valuing risk is very difficult task (at least before it materializes). It is also difficult to determine how risk is treated between unrelated parties. Although paragraphs 40 and 42 could support tax authorities in identifying and understanding risk, we are deeply concerned about the new and detailed standards set out in section D.2. Requiring analysis at this micro-level is virtually impossible to comply with in practice. The Draft seems to suggest that all risks should be identified and that the impact of each of those risks should be measured and analyzed in detail for each individual risk. With the number of legal entities and intra group transactions taking place in most MNEs, it is typically not possible to analyze every transaction and allocate reward for risk on a transaction by transaction basis, which in many situations seems to be required.
In principle, we agree with the assumption in para. 38 that it generally makes sense for third parties to be allocated a greater share of risks over which they have relatively more control. However, it needs to be acknowledged that risk allocation among third parties is far more complex and can be driven by a large number of factors which do not align with this general principle. By way of example, the perceived profit potential in a given business case, the perceived benefit for one of the parties or the valuation of a certain risk does frequently result in risk assumption which deviates from this general principle. As a concrete example, at arm’s length, the assumption of credit risk may be accepted by an exporting market company even though the detailed day to day control of that risk lies closer to the importing dealer company on the basis that the market company considers the risk to be very low and the dealer company is not willing to take on the sales activity carrying that risk. Therefore, the guidelines should be clarified as to say that the theoretical principle suggested in this paragraph (and elsewhere) can only be a starting point in the analysis.

In paragraphs 44 and 45 examples are provided regarding the allocation of risk. We strongly question these examples. Indeed, the selection of a certain transactional currency between independent parties will typically indicate the agreed allocation of F/X-risks. However, the same rationale is often not applicable between related parties. Although the transactional currency may very well be selected to indicate the agreed allocation of F/X-risk, between related parties this may be driven by other factors such as lack of system support, global hedging considerations etc. In addition, local F/X-regulations may make it impossible also for independent parties to select the trading currency in a way which aligns the “conduct” with the desired risk allocation as established in the contractual terms. Consequently, we do not support the conclusion that a deviation between the contractual agreement and the functional currency should be viewed as an example where the contractual terms should be ignored based on the conduct of the parties.

We have the same concern regarding the example in paragraph 45 regarding inventory write-downs. Accounting principles are typically not developed with consideration to the underlying objectives of the arm’s length principle. A write-down made in accordance with accounting rules has very little or nothing to with the allocation of risks between independent parties and we think that a risk allocation principle based on accounting standards often will be highly questionable from an arm’s length perspective. Consequently, we urge the OECD to recognize this and to delete this reference in the Draft. If not, local tax authorities may question any sound arm’s length risk allocation properly documented in agreements and TP-documentation based on the argument that it does not follow the conduct as indicated in the accounting.

It has been widely accepted by the majority of tax authorities that a party performing commercial activities could be insulated from commercial risk, provided of course that it is aligned with the substance required in chapter IX of the Guidelines. This has significantly facilitated compliance with the arm’s length principle for MNEs with
complex value chains. It has equally reduced the compliance burden while at the same time enabled tax authorities to focus their resources on other transactions with higher risk. Paragraph 49 of the Draft could change this existing practice and result in additional costs for both companies and tax authorities, with little additional revenue as a result.

The Confederation of Swedish Enterprise is worried about the language in paragraph 55 of the Draft. It is suggested that risk management comprises three elements: (i) the capability to make decisions to take on or decline a risk-bearing opportunity, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and (iii) the capability to mitigate risk. Within a group, risk related decisions are taken every day at every level of the organization. At a strategic and often central level decisions are taken about investments, budgets, corporate control functions, escalation models, customer funding strategies etc. At the same time, local day-to-day decisions involving risks are taken about individual customers, product quality improvements, warranty handling, workplace safety etc. etc. (typically based on the centrally developed and communicated guidelines and instructions etc.). Apart from the difficulty of identifying and valuing risk at the level of detail suggested throughout the paper, we think that further guidance is needed on what “actual performance of risk making decisions” means in this respect. Without such guidance, we see a considerable risk of increased disputes among tax authorities about the proper allocation of risks for TP-purposes (in particular in cases where substantial risks has materialized). In addition we see considerable risks that fully commercial and legitimate transfer pricing models with centralization of risk and IP which have been built up and accepted by a large majority of the tax authorities around the world will be impossible to uphold. The consequences of such a change would be detrimental, not only since it would significantly drive compliance and disputes, but also considering the fact that the commercial risks that have materialized in the aftermaths of the financial crises, in particular in cases of centralized principal TP-models, may no longer warrant the future reward for the risk taking entity/country.

On this basis, we believe that the guidelines need to further clarify what types of decision making functions that are required to be able to manage, control and thereby assume risks from a transfer pricing perspective. As day-to-day decision making regarding risks can (and often is) outsourced in third party situations, we believe that these decision making function should evolve around strategic decisions and control function that you can expect to be in place in cases where the day-to-day risk management is outsourced between third parties. Although we share the view that further detailing would be valuable, we believe that the principles set out in Chapter IX of the Guidelines about risk and control provides a sound standard. Indeed, we fully recognize the need to prevent unacceptable allocation of risk (and IP) to entities or jurisdictions without proper capacity, power or substance to assume those risks. However, without further clarity in this respect, we believe that the
suggested new guidelines would significantly drive compliance, uncertainty and disputes.

Paragraph 63, stating that risks should be analysed with specificity, in conjunction with the following paragraphs, underpins a general concern that the level of detail in which risks are supposed to be identified, analysed and valued under the proposed new standards are not on par with what is achievable from a practical perspective. Although in theory, a full functional and comparability analysis to assess the contributions by all of the associated parties to which risk relates (as required in para. 65) may be valuable, the tools to make such an analysis is typically not available. Comparable data is typically not available at this level of detail and hence the required level of risk analysis will often not be possible to comply with in practice. We feel that the paper largely neglects these practical challenges. Without the possibility to put the new Guidelines into practice, we see a risk that taxpayers will fail to live up to the new standards despite their best efforts to comply.

We acknowledge the statement in Paragraph 67 that risks may be transferred for a fee at arm’s length. We are concerned, however, with the use of the word “some” in the paragraph since it seems to suggest that this is more of an exception than the norm. We also question the implication later in this paragraph that a full transfer of core risks is unlikely to happen at arm’s length. The paragraph seems to assume that some risks, such as strategic, marketplace, infrastructure and operational risks, are more stationary than other risks and that they subsequently cannot be transferred at arm’s length between depended (or independent) parties. Although a marketplace risk clearly is stationary in the sense that it refers to a particular market, the paragraph fails to identify that the allocation of risk is not a question of transferring the risk as such. Instead it is a question of transferring the liability of a risk. Certainly in third party situations you can observe that the liability for certain market related risks are transferred to parties not operating physically in that market. Likewise, the liability to assume infrastructure risk may very well be allocated among third parties even though the risk itself geographically may be hard to relocate. On this basis, we believe that this paragraph needs to be closely reviewed.

As mentioned above, we appreciate the ambition to assist taxpayer and tax authorities in adopting and interpreting these new standards by providing examples. We do find these examples generally to be over simplified and overlooking much of the complex aspects of commercial business actives. The difficulty in providing clear and straightforward examples is e.g. highlighted in paragraphs 90 and 91. In the example, the fact that S1 is receiving 400 MUSD as an upfront payment for the IP is completely ignored. Although a cash rich and well consolidated company would probably not have conducted the transaction as outlined, a financially weak entity may very well make the deal at the terms set out in the example at arm’s length. This holds true in particular if the alternative is a risk of bankruptcy due to insufficient cash flow.

D3 Interpretation and D4 Non-recognition
For MNEs, certainty regarding tax rules is crucial. In order to increase predictability, tax rules need to be applied in a consistent matter by tax authorities. A decision not to recognize a transaction should only be made as a last resort. We believe that the proposed Guidelines should contain additional safeguards for compliant taxpayers, ensuring that they are not wrongfully caught by non-recognition.

When reading paragraph 85-87, the impression is given that all MNEs establish complex and fragmented structures to maximize their transfer pricing outcome. This is not the case. It needs to be acknowledged that the majority of taxpayers are compliant and interested in building good relationships with tax authorities. The key concern for most MNE groups is to have certainty in their tax affairs, not to maximize the outcomes of their transfer pricing.

Moral Hazard

1. Under the arm’s length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?

The Confederation of Swedish Enterprise believes that the concept of imputed moral hazard and contractual incentives may be difficult to apply for many MNEs.

Naturally, independent parties try to safeguard themselves in agreements against potential moral hazards on the side of their contractual partners. The level of detail in agreements will depend on volume and inherent risk of the transaction and the experience with the particular business party. Applicability for intercompany transactions will depend on industry and the availability of reliable data. Certain industries have more or less standard conditions in which also local legislation and consumer organizations play a role.

Availability of data like third party contractual terms is key. MNEs applying the T.N.M.M. or data base benchmarking against external companies will face extreme difficulties to apply the concept of imputed moral hazard and contractual incentives in their transfer pricing model. The simple reason for this is that the contractual terms of external companies found in a benchmark study are not known. The above leads to the conclusion that the concept of moral hazard must be made much clearer before it can be introduced in the BEPS concept.

2. How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?
In any Joint Venture a MNE may have this as a common element with a third party. Hence, it is not correct that this is only an element in a transaction with an associated entity. As such the internal contract can be the basis for assessing how the risks are placed.

One can split the risks mentioned in paragraph 42 into two categories of business risks; routine risks and non-routine risks. The difference between routine and non-routine risks is the availability of market and in house data about the occurrence of a certain risk. Routine risks can to a certain extent be quantified and benchmarked. Even in industries with high availability of risk data like insurance, certain seldom occurring events with big impact like war, nuclear explosions and flooding may be excluded from risk coverage.

The non-routine risks in 42 a) and b) are difficult if not impossible to benchmark. The insight in core competencies and future market opportunities may often be subjective but this insight has a big influence on future results. It may therefore lead to a transfer pricing model where routine operational companies receive routine profits and low risks. Residual results and risks are, and should be, allocated to the strategic decision taking functions/entities like global/regional or product division HQ that are supposed to have that insight. This will also be what is reflected in the internal agreement as it is in an external.

In relation to paragraph 43, and for the avoidance of doubt, it should be made clear that the focus is not on functional currencies but rather on the situation when the conduct of the parties deviates from the contractual agreement. If conduct and contract is aligned then parties must be free to agree on currency, F/X-risk placement etc.

3. **In the example at paragraphs 90 and 91 how should moral hazard implications be taken into account under the arm’s length principle?**

The example in paragraphs 90 and 91 describes an extreme and overly simplified case where functional trademark ownership seems to remain fully in S1 and the legal ownership is transferred to S2. S2 seems to have no insight in the business at all. This transaction as described faces the risk of non-recognition. The economic ownership seems to be split between entrepreneur S1 and the investor in the trademark S2. The moral hazard theory suggests that S2 is only entitled to a routine profit and S1, the entrepreneur with all insights should receive the residual return on the intangible, since S1 is the sole functional owner.

Modern practise within MNEs is clearly different and more complex than in the example in paragraphs 90 and 91. The core issue is the organisation of risk management as described in section D.2.5: MNEs have cross border "virtual" organisations, global specialist functions, product and or regional divisions and even specific project teams operating from several and changing business locations. The virtual organisations can manage the core business and core business risks, usually
under guidelines, policies and (monitoring) procedures set by the Global or Division HQ. The virtual organization in our example operates and works with no connection to each and every legal entity and jurisdiction. This further proves that the example used is not relevant for MNEs in many, if not all, cases.

The core question therefore is whether a Global or Division HQ or IP company should bear risk and therefore be entitled to risk (and intangible) related returns if it sets strategic targets and provides strategic funding but under strict guidance: policies & procedures and monitoring outsourced tactical management and execution to virtual organisations. The strategic and not the routine risk must be the key element.

Risk-return trade-off

4. Under the arm’s length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognised, how should they be treated?

Yes, in practise both independent companies and MNEs enter into transactions with the sole effect to shift risk. A company will consider transferring a risk if the economic impact of the risk can be significant and beyond control of the company. As mentioned in paragraph 67 some routine risks can be priced.

Similar to routine functions there are routine risks, risks that can be benchmarked with external market data and which can be swapped against cost of insurance or a financial instrument. Clear examples are: a) insurance coverage against risks for costs of medical treatment, destruction or damage of property and liability or b) the use of financial instruments to mitigate the fluctuations of foreign currencies, commodity prices and interest levels.

To a certain extent the risks mentioned in paragraphs 42 c)-e) can be seen as routine risks that can be priced and transferred on a sole base.

Important business risks and sometimes also the potential impact of such risks are indicated in MNEs annual reports. Transfer Pricing documentation reports should therefore also include a risk paragraph, which summarises the most important risks, their potential impact and whether the risk can be priced/benchmarked or not. For many MNEs this is already the case.

Tax authorities should proceed cautiously before considering not recognising the transfer of risks and risks related income to the investor mentioned in example 65. In practise investors may not have detailed knowledge to assess, monitor and direct risk mitigation actions but may simply rely on the advice of external experts. Examples are investments in private equity, hedge-funds, stocks, real estate, commodities, bonds, options, futures or insurance underwriting where the mitigation
actions are managed by external advisors against a certain fee, whereby the advisor does not bear risk.

In this respect, and as indicated in our comments above, we have serious concerns about the principles and consequences of risk management in paragraph 55. The risk management decisions and capabilities to assess, monitor and direct risk taking and mitigation may in practice be spread over various layers and functions within a MNE. It is virtually impossible to allocate risks and risk-related income over all layers and functions involved. This could be illustrated by the following example:

Example

In this example the MNE HQ is based in country A, the division HQ is based in country B, and factories in country C and D and group/division support functions in country D and E.

In a specific consumer durables industry there is a mature geographical market for a specific product. Future sales will depend on replacement sales and product innovations. Due to decline in the economy, entrance of new players and improved production technology there is production overcapacity in the industry and within a specific MNE division. There is a declining sales and EBIT trend for the division responsible for this product/market combination.

In a specific year group staff notices that the declining trends are getting worse. The Group Marketing department buys marketing services from an external service provider. The external market data include sales volumes, average sales price and consumer spending power per country. Group Marketing analyses the external market data and reports market trends to Group management. The Group Controlling and Accounting departments analyse and report the financial performance of each division to Group management.

Based on this input Group Departments Group Management decides that the responsible division should take action to stop declining sales by improving product portfolio, restore profitability by cutting purchase costs of external sourced materials and cutting overhead and production facilities within the division. A division taskforce with team members from various countries and supported and monitored by Global Departments and external consultants develops plans to meet the targets.

It appears that the factory in country C has a location disadvantage compared to other manufacturers in same region, including factory D. The labour and social contribution costs per unit and transportation costs per unit to most relevant markets are very high compared to other countries. The factory in country C would be lossmaking if it could only invoice at standard production costs per unit, based on average labour costs in the region plus a profit markup.
The factory in Country C supported by division task force, based in A, B, C, D and external consultants prepares a plan to become more cost competitive.

This example illustrates that decisions and risk mitigating actions, including directing, accessing, monitoring and executing are taken at various levels, by various functions and in various countries. It would in practice be impossible, and also incorrect, to allocate risks and risk related income over all layers, functions and countries involved.

This real life example differs significantly from the assumed risk management model in paragraph 55, which suggest that the capability to take decisions and assess, monitor and direct outsourced decisions are all based in the same location.

5. In the example at paragraphs 90 and 91, how does the asset transfer alter the risks assumed by the two associated enterprises under the arm’s length principle?

6. In the example at paragraphs 90 and 91, how should risk-return trade-off implications be taken into account under the arm’s length principle?

Comments on questions 5 and 6:

As mentioned previously, this is an extreme and oversimplified example not relevant for most MNEs. The example in 90 and 91 is an extreme situation in which the transaction most likely should not be recognised. Company S1 still performs all relevant functions like before and Company S2 performs only administrative functions. In this example it should be investigated which functions/company truly takes the Company S2 risk related decisions and whether the functions in Company S2 in practise have any decision taking authority at all. Company S2 most likely has an effective management based at the HQ of S1 and should be taxed accordingly. If the transaction is recognized at all, Company S2 should bear only the investment risk on its lump-sum payment, S2 risks are the interest rate risk and default risk of S1. Company S2 should get a routine return on its lump sum investment with a return rate comparable with a long term bond of parent company S1. The example cannot and should not form part of an important document like the one now discussed.

7. Under the arm’s length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk? If so:

a) Are there limits to the extent that the risk-return trade-off should be applied? For example, can the risk-return trade-off be applied opportunistically in practice to support transactions that result in BEPS (for example by manipulating the discount rates to “prove” that the transaction is economically rational)?
b) Are there measures that can be taken in relation to the risk-return trade-off issue to ensure appropriate policy outcomes (including the avoidance of BEPS) within the arm’s length principle, or falling outside the arm’s length principle?

The real questions are whether there is a business rationale for shift in risk and whether the risk management function are indeed managed by the transferee. If the answer to those questions is yes, than the risk taking party should be compensated appropriately for taking the risk.

The example in 90 and 91 will most likely lead to non-recognition since there is no business rationale and no functions with the transferee that effectively manage the risk.

In relation to question a) recognised transactions which also include a shift of risk should be valued according to standard valuation techniques like DCF method. The most problematic part in such a valuation is the reliability of forecasts rather than setting an appropriate discount rate. Both MNEs and tax authorities should be careful of a duplication of uncertainties and opportunities in used forecasts and discount rate.

In relation to b) the tools to attack these types of fake transactions, for which BEPS is intended, are already available in the current OECD transfer pricing guidelines. MNEs should provide tax authorities access to all relevant information to judge the validity and valuation/benchmarking aspects of the transaction. Tax authorities should properly train specialists, including language skills, to evaluate transfer pricing aspects.

The concept of non-recognition, also referred to as recharacterisation should only be applied in situations comparable to examples 90-91, where the transaction clearly lacks the fundamental economic attributes of arrangements between unrelated parties and when tax savings appear to be the leading motive to structure a transaction in a specific way.

The main and biggest risk for a MNE and for its shareholders is the risk of double taxation. In order to provide certainty and predictability for the MNE and its shareholders, non-recognition can and should not be available to the tax authorities in other than exceptional cases.

It must be clear when non-recognition can be considered and it must and should follow main principles under the rule of law, meaning legal certainty and predictability. Only if it is apparent that the leading motive is tax driven then non-recognition is to be allowed. In cases where a proper and genuine business case
exists then the tax authorities cannot use the measure to non-recognize the transaction.

**Part II - Special measures**

Special measures create additional uncertainty for taxpayers. The Confederation of Swedish Enterprise believes that the analysis of commercial and financial relations, together with (if necessary) the application of non-recognition rules, should be considered enough to guarantee a proper remuneration of the intragroup transactions within MNEs. For these reasons, we find no need for these special measures in order to avoid BEPS behaviors.

If they are to exist there must be a clear and consistently applied set of criteria for their application. It should be clearly expressed that they should apply only in exceptional cases. They also need to be applied consistently by all tax administrations in order to avoid an increase of tax disputes and potential double taxation.

**Option 1: Hard-to-value intangibles**

Option 1 will likely lead to complications and increased administrative burden. MNEs should have the freedom to choose the form of the transaction within the boundaries of the at arm’s length principle. Introducing a special measure available to the tax authorities that would allow them to use the benefit of hindsight in a re-assessment for tax purposes is not aligned with the above discussion on strategic risk. Early development projects are always a “hard to value intangible” and introducing a new element in this context would create great uncertainty.

This is nothing new and is also considered in a third party transaction. If the risk by one party is viewed to be manageable or that it is unlikely to materialize then he is willing to pay more. On the other hand if the risk is difficult to assess and viewed as likely to materialize then he is willing to pay less. This is already covered in any valuation report and is as such then already included as basis for a business decision (irrespective if they are internal or external).

It is not reasonable to expect the same level of documentation and sophistication in adjustment clauses for intangible transactions with relative low value.

In highly uncertain situations it may be problematic to adjust the tax and accounting implications retrospectively if the original transaction was done via a lump sum payment. Can the transferor effectively receive corporate income tax back in the tax year when the transaction is done if the value is adjusted downwards five years
later? As stated above the paramount objective is to avoid double taxation and to ensure a predictable tax and business environment.

It is important to understand which elements in a valuation are highly uncertain and beyond control of the transferee. After all it is not logical that a transferor of an intangible should bear operational, transactional and hazard risks of the transferee if these risks are not directly related to the transferred intangible.

A transferee will try to seek coverage for market place risk beyond its control; payment is therefore linked to a specific development or event like government approval for medicines. This risk coverage can be achieved either via the purchase price of the intangible or via a price adjustment clause.

A trademark or technology royalty rate is normally set as a percentage of sales or per sold unit. The royalty rate setting depends on available benchmark material like third party royalty agreements and expected intangible related income for the licensee.

Both licensor and licensee will make projections of their respective income of the license agreement but retrospective royalty rate adjustments are not common. The question is how the transaction should be characterised if the licensor’s royalty is directly depending on the profit of the licensee’s enterprise, which is more a joint venture than the license of an intangible. Tax treatment of joint ventures is totally different from intangible related income.

In conclusion, we see a risk that option 1 it may open up for arbitrary use of hindsight. A better approach in our view is to include general guidance on the use of adjustment clauses recommending that such instruments should be used when it can be expected in third party situations and also outlining some guidance on how such clauses typically are designed.

Option 2: Independent Investor

It is unclear to us what option 2 is exactly aiming at. It appears to be very subjective and we fail to see how this option could be developed into a rule which is sufficiently clear and adaptable to various market conditions and industries and which do not hamper genuine business activities. Consequently, we do not support this option.

Option 3: Thick capitalization

The tax treatment of both interest deduction and interest income should be based on the same set of ratios and rules.
The rationale of financing business activities and assets is mainly driven by the risk characteristics of the asset. Higher embedded risk implicates a lower debt/equity ratio.

Reference can be made to the Basel 2 and 3 guidelines for banks. Some entities may hold high liquidity and have high equity in anticipation of future acquisitions, so tax savings are not the leading motive.

In both thin and thick capitalisation situations it should be investigated whether there are sound business reasons for the financial transactions or whether only tax saving is the leading motive for a financial transaction.

The capital ratio varies considerably between MNEs in differing sectors. As with option 2, we fail to see how this option could be developed into a rule which is sufficiently clear and adaptable to various market conditions and industries and which do not hamper genuine business activities. Therefore, we do not support this option.

**Option 4: Minimal functional entity**

There is a rationale for introducing minimum thresholds of functionality, both qualitative and quantitative, depending on the type of activities that entities are involved in and the industry in which the MNE operates.

Whether an entity is only involved in intercompany transactions is not an effective threshold for functionality. Should it make a difference whether a principal company has external transactions because it operates with a sales agent/toll manufacturer structure? The key question is whether an entity has the core functions to run its business.

It will be difficult to set pre-determined factors to allocate profits, but also assets and risks if a legal entity would fail the functionality threshold.

As stated above in relation to options 2 and 3, we fail to see how this option could be developed into a rule which is sufficiently clear and adaptable to various market conditions and industries and which do not hamper genuine business activities and we consequently do not support this option.

**Option 5: Ensuring appropriate taxation of excess returns**

CFC legislation leads to taxation of untaxed profits in the parent jurisdiction. Whether or not the taxes related to excess returns economically belong there is another matter. Therefore, maintaining and enforcing the arm's length principle via
the transfer pricing guidelines is the correct way to tax excess profits where they should be taxed.

If there are sound business reasons to use a certain jurisdiction, such a business decision should be accepted without the risk of CFC-taxation.

However, in comparison with the other options in the Draft, we believe that option 5 is the most reasonable one. Appropriately designed CFC-rules have the potential to mitigate important BEPS behavior. Importantly, however, there needs to be a universal agreement on what is considered as an unacceptable tax level (and hence when CFC-taxation should be triggered).

On behalf of the Confederation of Swedish Enterprise

February 6, 2015

Krister Andersson
Head of the Tax Policy Department
Andrew Hickman,
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
OECD

By email: TransferPricing@oecd.org

6 February 2015

Dear Andrew

BEPS Actions 8, 9 and 10: Discussion Draft on revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures)

Thank you for the opportunity to comment on BEPS Actions 8, 9 and 10: Discussion Draft on revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures) published on 19 December 2014 (the ‘Discussion Draft’).

Executive summary

Risk, along with functions and assets, is a key factor in analysing transactions between group companies in order to compare them with those undertaken by independent parties. Further guidance on considerations in relation to risk will be welcome for businesses and tax authorities, particularly where this clarifies how transactions should be considered in relation to the practical application of the arm’s length principle. The term ‘risk’ has different meanings for different people. To economists, risk means uncertainty. In other common usages, it might mean risk of loss – the downside. It would be helpful if the guidelines were to define risk for the purposes of applying the arm’s length principle.

We agree that the first important step in any transfer pricing analysis is defining the economically relevant characteristics of the transaction that is actually undertaken, by reference to the contractual arrangements and the conduct of the parties. Where the conduct of the parties differs from the contractual arrangements, then we agree that it is the conduct of the parties that is determinative.

It is essential, to enable compliance and to minimise disputes, for the OECD to clarify the standards that businesses (and tax authorities) are expected to apply. To the extent that (as we understand to be the case) risk and recharacterisation are to be applied in relation to the arm’s length standard under Article 9 of the OECD Model Tax Treaty, then all guidelines should refer to evidence of what would happen between third parties. This would clarify some areas (e.g. the problematic discussion of moral hazard could be removed in its entirety, as there is clear evidence of moral hazard between third parties) and would provide a suitable test for resolving disputes. This would also aid discussions on the return to be
awarded to capital, which clearly does have a value in transactions between unrelated parties.

The practical application of transfer pricing in a proportionate manner in a way that minimises dispute is key to its success. Where transactions are complex, include high levels of uncertainty of outcome, valuable intangibles, business restructurings or highly integrated activities in a manner rarely seen between third parties, then it will be appropriate to devote time to ensure that risk (as well as functions and assets) have been analysed correctly. For example, the concept of ‘options realistically available’ that is currently included in Chapter IX of the OECD’s *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (‘the OECD guidelines’ or ‘the transfer pricing guidelines’) on business restructurings may be appropriate and proportionate in relation to such transactions. However, it is less likely (depending on the facts and circumstances of each case) to be necessary, proportionate or appropriate in relation to more straightforward and commonplace transactions such as the provision of services or distribution activities. The key question to ask is what third parties would have done in comparable circumstances – and in many cases there is little or no doubt. It would be helpful if the OECD could consider reflecting in guidance that the need to consider options realistically available relates to complex matters where there is potential for dispute and disagreement, so that this does not become a compliance burden for businesses in respect of all transactions.

Risk, and in particular risk and associated returns related to capital, is of fundamental importance to financial services businesses. It has been the subject of considerable discussion between tax authorities and businesses, as well as regulators, for many years. Any general discussion of risk for other businesses is unlikely to deal adequately with considerations for risk in relation to capital providers in the financial services sector, particularly given regulatory capital requirements. There are two options here – the first is that the OECD provides detailed additional guidance in relation to risk and capital for financial services businesses. The second is that regulated financial services are carved out of the discussion of risk in these proposed changes to Chapter I under the BEPS project, to be dealt with in later work drawing on input from the industry. Given the timetable for the BEPS process and the consequences for dispute and double taxation, we are of the view that the second option is preferable.

Recharacterisation (or non-recognition) of transactions remains a key area of concern, given the potential for dispute and double taxation. At the very least, there needs to be further guidance on how ‘fundamental economic attributes of arrangements between unrelated parties’ would be evaluated in different situations. For example, in a business restructuring context, the decision to close down high cost manufacturing operations in one location and begin manufacturing in another location where, for example, labour is cheaper is clearly a commercially rational decision for the group as a whole. However, would it offer the original manufacturing entity ‘a reasonable expectation to enhance or protect their commercial or financial position’ compared to other opportunities realistically available? This will depend on the circumstances, but it does not appear to be appropriate for tax rules to give continuing reward to the first location in this example (and would not be consistent with Chapter IX on business restructuring). The example provided relates to cash box companies and financing, and we question whether, outside of this narrow area, recharacterisation is an appropriate concept given the extensive work on application of the arm’s length principle undertaken as part of the BEPS project. To the extent that recharacterisation remains within the guidelines, there need to be safeguards around how it should be applied, including for example a requirement for joint audits and agreement with treaty partners up front to ensure disputes and double taxation are minimised.

The section on special measures, outside of the arm’s length principle and which will require amendment to Article 9 of the Model Tax Treaty, is clearly at an earlier stage of discussion. Any special measures targeting areas of abuse should be applied after application of the arm’s length principle, rather than as a short cut to get around a transfer pricing analysis.

Detailed comments on specific aspects of the Discussion Draft are set out in the attached appendices.
If you would like to discuss any of the points raised in this letter, please do not hesitate to contact either me (bdodwell@deloitte.co.uk), John Henshall (jhenshall@deloitte.co.uk) or Alison Lobb (alobb@deloitte.co.uk). We would be happy to speak on this topic at the public consultation meeting in March 2015.

Yours sincerely

W J I Dodwell
Deloitte LLP
APPENDIX 1: Comments on proposed modifications to the provisions of Chapter I, Section D of the Transfer Pricing Guidelines (Part I of the Discussion Draft)

This appendix sets out comments on some of the proposed modifications to the provisions of Chapter I, Section D of the Transfer Pricing Guidelines, as set out on Part I of the Discussion Draft.

Comments in respect of proposed Section D.1 – Identifying the commercial or financial relations (paragraphs 1 to 35)

These paragraphs are generally helpful. A full functional analysis will be required to determine the transaction that is to be priced before any questions on selection of method or pricing analysis can be answered. We agree that where there are differences between contractual arrangements and conduct of the parties, it is the conduct of the parties that will be determinative.

Paragraph 21 discusses the capability of a multinational entity to ‘fragment even highly integrated functions’ which require coordination. This point should be considered in light of the arm’s length principle – businesses, whether multinational or not, can and do outsource many functions to third parties, and such outsourced activities need to be coordinated and managed as part of the outsourcing process. Third party comparable data, whilst giving value to efficiencies from the outsource provider’s specialisation, will take this need for coordination into account. Where functions are so highly integrated that third party comparable data does not exist, then it is possible that the most appropriate method for transfer pricing will be a profit split (see our comments on Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains).

Comments in respect of proposed Section D.2 – Identifying the risks in commercial or financial relations (paragraphs 36 to 78)

Parts of this section, including the framework for evaluation of risk, would be improved if they included a clear reference to the need to consider how third parties in comparable circumstances control, manage and bear risk. This would allow for differences within sectors (notably the financial services sector – see further below) and facts and circumstances.

The examples in paragraphs 42 et seq. are helpful illustrations and will assist with the identification of risks. It is important that these are treated as examples only, and do not become an exhaustive or prescriptive list. The guidelines should reiterate the importance of taking into account the specific facts and economically relevant circumstances of the transactions in question. This is best practice today, in accordance with current guidelines, and it is important that additional detail and illustration do not inadvertently mask this fundamental point.

In particular, as business models may differ substantially, there may be different outcomes for different businesses even where they operate in the same industry.

We agree with the general principle that in many third party situations risks, and the profits and losses that follow such risks, will be aligned to the functions of the people managing and controlling them. A joint venture model may provide useful third party evidence. However, there are some situations where between third parties this will not be case (see discussion of financial services below).

It is important to note that taking on risks can result in commercial losses. Whilst the examples set out how profits should be allocated depending on how risks are managed, it would be helpful to include examples showing how losses would be allocated. In general, one would expect symmetrical treatment of profits and losses i.e. a company that would receive a profit (e.g. because it undertakes functions including the management of risk) should also bear a loss arising from the downside and/or inability to control the same risk. However, the determining factor would be the behaviour of third parties in similar
circumstances (see in particular the comments on the financial services industry below). Where third parties agree an allocation of risk in contractual arrangements, this is the best evidence of how similar risks should be allocated between group companies. This allocation should be consistent with the conduct of the parties, and documented. In third party situations, key identified risks and the allocation of profits and losses will form part of contractual terms, and an entity will not bear a loss unless it is contractually, legally obliged to do so. This is an important issue, as experience has shown that some of the most difficult transfer pricing disputes, particularly but not limited to the financial services sector, have been about which entity should bear losses.

A related losses point is in connection with ‘unknown unknowns’. The Discussion Draft is based on an assumption that all of the risks that will be faced by companies can be identified and managed as far as possible, such that there is a clear function to which they can be allocated. However, there are risks – ‘unknown unknowns’ – which are not identified at the start of a project, and are not managed, but which may affect the outcome materially or may result in losses. Where the outcome is determined by events that have not been managed – typically market or other external risks – then it will not be possible to determine the allocation of profits or losses arising from these risks by reference to functions. Between third parties, the legal (contractual) position will be determinative.

Moral hazard

Q1. Under the arm’s length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?

Q2. How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?

Q3. In the example at paragraphs 90 and 91 how should moral hazard implications be taken into account under the arm’s length principle?

Moral hazard is not something that should be analysed differently for multinational groups. It is clear that the economic concept of moral hazard exists in arrangements between third parties, and as such is priced into comparable data. It is also not the case that entities within a group act solely in their own interest or solely in the group’s interest. In most third party cases, the nature of the transaction means that the objectives of both parties are aligned, and this is the case within multinationals as well. If an arm’s length approach is rejected in order to analyse moral hazards within a group (and we fail to see how this could be done on an objective basis), then this would be outside existing Article 9 of the Model Tax Treaty, and would need to be a special measure. If the arm’s length principle is rejected for analysis of risks, but retained for an analysis of functions and assets, this would give an odd and unsatisfactory result that will lead to inevitable dispute and double taxation.

The more appropriate answer is to consider risk within the functional analysis, selection of method and economic analysis including selection of comparables.

Risk-return trade-off

Q4. Under the arm’s length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognised, how should they be treated?

Transactions with the sole effect of transferring risk are financial transactions. Other transactions may have the effect of transferring risk, but only alongside activities and/or assets. Insurance is the most
common example of transactions whose purpose is to transfer risk. Guarantee arrangements and derivatives are other examples.

As discussed, the detail required to properly evaluate financial services transactions including risks and the reward to capital, means that we think this work will require significant time and input including from the financial services industry.

Q5. In the example at paragraphs 90 and 91, how does the asset transfer alter the risks assumed by the two associated enterprises under the arm’s length principle?

Q6. In the example at paragraphs 90 and 91, how should risk-return trade-off implications be taken into account under the arm’s length principle?

Q7. Under the arm’s length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk? If so:

a) Are there limits to the extent that the risk-return trade-off should be applied? For example, can the risk-return trade-off be applied opportunistically in practice to support transactions that result in BEPS (for example by manipulating the discount rates to “prove” that the transaction is economically rational)?

b) Are there measures that can be taken in relation to the risk-return trade-off issue to ensure appropriate policy outcomes (including the avoidance of BEPS)?

See above – this is a financing transaction, and the arm’s length principle will reward it as such. Addressing any issues with the provision of finance from a low-tax jurisdiction should be dealt with outside of transfer pricing – for example via CFC rules, interest restrictions or other measures. The risk-return trade-off is related to the finance transaction. Between third parties, securitisation of income streams would achieve this result. Finance transactions are economically rational.

Financial Services Sector

Q.8 Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?

We consider that it is essential that a distinction should be made. Indeed, the proposed revised guidance, if implemented as currently drafted, would create significant risk of double taxation for regulated multinational financial institutions. We have set out our reasons for this view below.

Regulation

Businesses operating within the financial sector are highly regulated. This regulatory framework is a critical business driver for how businesses in this sector operate. Regulators can require businesses to structure themselves legally in particular ways – for example requiring a group to establish a subsidiary in a particular country rather than operating as a branch and have established detailed rules to determine the minimum amount of capital legal entities must hold. Regulators are unlikely to accept the premise in paragraph 66 of the Discussion Draft that ‘a low level of capital in a controlled enterprise should not prevent the allocation of risk to the company for transfer pricing purposes’ if that meant in practice that that entity would have to bear actual losses. The amount of regulatory capital in a financial services group is a precious resource and groups go to great lengths to ensure that the capital is managed as efficiently as possible. This means that often risks are concentrated in specific legal entities in order to use regulatory capital efficiently. Allocation of capital to subsidiaries through the injection of equity into
those entities is typically avoided where possible as it leads to wastage of regulatory capital as the equity in the subsidiary may not be fully recognised as regulatory capital at the parent company level.

The rules as to how to calculate regulatory capital vary from regulator to regulator and banking and insurance take different approaches (although in many cases the local rules are based on broad international frameworks such as the Basel rules that apply to banks). Nevertheless, a key principle that is almost universally applicable is that the regulatory capital requirements of a particular entity are driven by the contractual legal arrangements that entity has entered into both with third parties and related parties. However, the day to day management of those risks is often dispersed both geographically and across legal entities so that the entity bearing the risk from a legal and regulatory capital perspective may not actually employ the staff who manage those risks but rather has outsourced some of those functions to other legal entities within the group.

As a result, there is a potential conflict between the approach to allocating risk proposed by the Discussion Draft and that required by the regulators. As noted above, the management of risk in a multinational financial group is in practice often dispersed. Under the approach outlined in the Discussion Draft, this could lead to the suggestion that risk should be allocated to locations/entities which perform those functions rather than the booking entity. However, as noted above, regulators, as a general rule, do not pay attention to the ‘conduct of the parties’ when determining the allocation of risk and therefore an allocation of risk for transfer pricing purposes which is driven by ‘the factual substance of the transaction as reflected in the conduct of the parties’ (paragraph 43) risks coming into conflict with the regulatory allocation of risk between entities within a group.

This conflict is likely to be particularly acute with respect to the allocation of losses arising from market transactions the financial sector group has entered into. Indeed, under existing rules we have seen regulators taken an increasing interest in the transfer pricing policies of multinationals. This has been particularly apparent in the area of remote booking. As noted above, banking groups often organise themselves such that financial positions (and the market and credit risk associated with those positions) are booked onto a central booking vehicle in order to maximise efficiency from a regulatory capital perspective. The traders booking the trades and managing the market risk associated with those positions are frequently geographically dispersed and employed by multiple entities across multiple jurisdictions.

We have seen examples where regulators in a jurisdiction which employs the traders have required groups either to change their transfer pricing policies such that there is no possibility of losses being transferred from a booking entity to the entity employing the traders or to set aside regulatory capital in the entity employing the traders to cover the possibility that losses might be transferred. The latter course of action is normally highly undesirable from a commercial perspective as it leads to wastage of the regulatory capital resources of the group as the booking entity will be required by its regulator to set aside regulatory capital with respect to these positions as well. Tax authorities in some jurisdictions have deferred to the regulator when it comes to the allocation of losses between legal entities within a group. In addition, it is not just regulators and capital that drives booking in one entity, as customer preference and systems also play a part.

The approach outlined in the Discussion Draft is likely to make this problem more acute. As a result we see significant risk of double taxation where financial sector groups have made commercial losses due to the risk that they struggle to obtain tax relief for those losses due to disputes between tax authorities over where those losses should be attributed for tax purposes.
As a minimum, the proposed revisions should be amended to take into account the special circumstances of regulated multinationals operating in the financial sector and that for this sector the starting assumption should be that for regulated entities the regulatory approach to the allocation of risk should be respected for transfer pricing purposes.

**Capital and losses**

As the Discussion Draft notes, risk is the stock in trade of the financial sector. As the financial crisis showed, risks in the financial sector can rapidly translate into significant losses. In order to be able to take on the risks inherent in the sector, multinationals operating in the financial sector need substantial capital. This is normally a regulatory requirement. However, commercially an enterprise will not be able to do business in this sector unless it holds appropriate levels of capital as third parties will be reluctant to transact with undercapitalised entities due to the risk of them not being prepared to meet their obligations.

Much effort has been expended by both taxpayers and tax authorities in addressing the complex transfer pricing problems that have arisen as a result of the expansion of the financial services sector and financial services multinationals over the past couple of decades. However, a fragile consensus has emerged over the last few years on the side of both taxpayers and the tax authorities in the main financial centres that capital should be treated as something distinct from the people who manage the risk that is backed by that capital and needs to be priced separately. It is normally also the case that the capital provider absorbs any losses arising from the risks it has taken on.

The approach outlined above is in line with the ‘investor/fund manager’ example in paragraph 9.25 of the OECD Guidelines. This example reflects the importance of capital in the financial sector and should be retained as an approach to the pricing of transactions within the financial sector. The approach to allocating risk as set out in the Discussion Draft is arguably incompatible with this approach. There are particular concerns that tax authorities with relatively small financial sectors and little experience in addressing the problems that arise from these transactions will use the approach in the Discussion Draft to challenge a reward being allocated to the capital provider, which would lead to more disputes over double taxation.

The proposals should be amended to make it clear that in the financial sector the provision of capital provides a critical risk bearing function distinct from the people who manage the risks that the capital backs and transfer pricing policies in this sector need to take this into account.

**Comments in respect of proposed Section D.3 – Interpretation (paragraphs 79 to 82)**

No comments on paragraphs 79-81. See comments on paragraph 82 below.

**Comments in respect of proposed Section D.4 – Non-recognition (paragraphs 83 to 93)**

Paragraph 82 (i.e. the paragraph preceding Section D.4) confirms that, as under the current guidelines, non-recognition should apply only in ‘exceptional’ circumstances. However, Section D.4 does not comment on the expectation. The introduction to section D.4 should reiterate and clarify the meaning of ‘exceptional circumstances’.

The use of the phrase ‘interpreted as’ in paragraph 82 should be deleted. It is not clear what purpose introducing this level of uncertainty serves for either businesses or tax authorities.

Recharacterisation of transactions is contentious and a source of double taxation. We agree that it should be a matter of last resort, and every effort should be made to understand and price the transactions that are actually undertaken. In particular, the arm’s length principle applies to determine the
level of profit and loss that is to be attributed to parties based on what third parties would do. This is a
principled approach, and it is the principle that allows for a basis for resolving disputes. The arm’s length
principle does not consider factors outside the economic analysis of transactions, such that, for example,
it does not take into account the tax rate of the parties. In the example given in paragraphs 90-91, the
arm’s length principle will correctly restrict the return to Company S to a finance return given its lack of
functionality. Were Company S to be in a high tax jurisdiction this would be the same answer. The
analysis that an investor would prefer to invest directly in the functional company is unsupported and
would need to be determined by reference to the behaviour of third parties.

The term ‘fundamental economic attributes of arrangements between unrelated parties’ will need further
clarification and guidance. It would appear that transactions that are seen between third parties would
have these attributes, and therefore this section is referring only to transactions that do not occur between
third parties. It would help if this is made clear.

There are two significant issues with recharacterisation in terms of dispute and double taxation – 1) that
two or more tax authorities do not agree when it should apply, and 2) that two or more tax authorities do
not agree on the alternative transaction that should be priced. For these reasons, businesses are
understandably concerned about the potential uncertainties caused. There are a number of safeguards
that the OECD could adopt here, consistent with the work under BEPS Action 14 in relation to improving
dispute resolution processes:

- That recharacterisation applies and the alternative transaction to be priced should require mandatory
  agreement of competent authorities under Article 25 Mutual Agreement Procedures (‘MAP’) for treaty
countries. If such agreement is not reached, the default position will be to price the transaction
  actually undertaken. (Note that this is not the same as mandatory binding arbitration, as it is the
  approach that is being decided rather than the outcome under it).
- In the absence of such mandatory agreement, the monitoring process for MAP envisaged under
  Action 14 should include specific review of and publication of the number of cases where there has
  been unilateral application of recharacterisation of transactions.

It would also be helpful for examples to be given of straightforward cases where recharacterisation should
not be considered – including services, distribution, manufacturing and other situations where evidence of
comparable transactions are available in developed markets. Recharacterisation would not be applicable
to transactions where the profit split method is applied.

Paragraph 89 states ‘in order for the transaction as accurately delineated to be recognised for transfer
pricing purposes, the transaction should exhibit the fundamental economic attributes of arrangements
between unrelated parties. An arrangement exhibiting the fundamental economic attributes of
arrangements between unrelated parties would offer each of the parties a reasonable expectation to
enhance or protect their commercial or financial positions on a risk-adjusted (the return adjusted for the
level of risk associated with it) basis, compared to other opportunities realistically available to them at the
time the arrangement was entered into. If the actual arrangement, viewed in its entirety, would not afford
such an opportunity to each of the parties, or would afford it to only one of them, then the transaction
would not be recognised for transfer pricing purposes.’

If we consider a commercial example as follows: Company X is the parent company of a multinational
group. It has two subsidiaries engaged in similar manufacturing business, Company Y in country Y and
Company Z in country Z. Company Y has only one contract - a manufacturing contract with a third party-
shortly up for renewal. Both Company Y and Company Z have the capabilities and the capacity to fulfil
the contract. However the operating costs (labour, overheads) in Company Z are lower. If it were to
perform the manufacturing contract, the group would earn a margin of 15% over costs, rather than 5%
earned by Company Y. From a group perspective, it is clearly commercially rational (on a pre-tax basis)
for the new contract to be performed by Company Z. However, if Company Y’s position is examined in isolation, the action which would offer a Company Y a reasonable expectation to enhance or protect its commercial or financial position would be to renew the contract itself and continue to earn a 5% margin. We appreciate that this is a business restructuring example, and it is important that any new guidance on recharacterisation in Chapter I is consistent with that in Chapter IX of the OECD Guidelines. We also recognise that perhaps in this example Company S does not have any options realistically available to it. However, applying this example illustrates the difficulties of looking at commercial rationality on both a group and entity basis, and illustrates the potential for disputes.
APPENDIX 2: Comments on Part II of the Discussion Draft – Special Measures

It is clear from the Discussion Draft that the need for specific special measures, outside of the arm’s length principle, are at an earlier stage of development than the sections on risk and recharacterisation. There are some specific points of principle that should be taken into account in relation to further work as to if, and if yes, when, special measures should be in point.

- Special measures are not compatible with the arm’s length principle, and as such will require amendment to Article 9 of the Model Tax Treaty.
- Special measures should not be a substitute for proper application of the arm’s length principle, and should be applied only after application of the arm’s length principle and transfer pricing.
- It is essential that special measures allow for dispute resolution and relief from double taxation in the same way as other treaty matters.

That said, where special measures are targeted towards narrowly-defined specific areas of concern, then it will be clear to businesses and tax authorities when they are in point. These are, in effect, anti-abuse rules. In some cases we think that the issues and the proposed solutions would be better dealt with under other areas of the BEPS project, such as the work on CFCs and interest restrictions.

In considering the implementation of a special measures which override the fundamental arm’s length principle, it would be helpful to follow an approach similar to that adopted by the example set by the Task Force on the Digital Economy (as set out in their paper Addressing the Tax Challenges of the Digital Economy – 16 September 2014) and apply the principles of the 1988 Ottawa taxation framework, the key principles being neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, and proportionality.

**Option 1: Hard-to-value intangibles (‘HTVI’)**

Third party transactions include a variety of contractual arrangements – those where there is no price adjustment clause and the parties close the transaction and walk away, and those where a price adjustment clause is agreed. As such, this is not an arm’s length approach. However, if related parties are required to impute a price adjustment clause for transfer pricing purposes then this would be a pragmatic measure (at least for prospective transactions) as related party contractual terms would incorporate contingent payment mechanisms to ensure symmetry of treatment. It is essential that this symmetrical treatment is available for transactions.

**Option 2: Inappropriate returns for providing capital – Independent investor**

The extreme level of subjectivity required in relation to this measure makes it a potential source of dispute and double taxation – and unlikely to be workable. In addition, proper application of the transfer pricing rules will ensure that the return to a company without functional activities will be limited to that of a finance provider. There is a clear overlap with Action 3 on CFC rules and Action 4 on interest limitations. As a minimum this option should be focussed on situations where the capital-rich, asset-owning company is subject to a low tax rate.

**Option 3: Inappropriate returns for providing capital – Thick capitalisation**

Proper application of the transfer pricing rules will ensure that the return to a company without functional activities will be limited to that of a finance provider. This special measure should, at a minimum, be targeted at minimally functional capital-rich companies that are subject to low rates of tax. It should also be coordinated with the work on Action 4 on interest and on Action 3 on CFCs.
Regulated financial services capital requirements are unlikely to be helpful in setting any ratios. These differ from industry to industry (e.g. insurance and banking have different requirements) and also in their implementation and interpretation by different countries.

Option 4: Minimal functional entity

This special measure is redundant. Transfer pricing under the arm’s length principle, including the new guidance developed under the BEPS project, will allocate such an entity minimal profits. It should not be used as a shortcut to avoid the application of a transfer pricing analysis. Whilst a profit split method may be appropriate for some circumstances linked to the qualitative and quantitative attributes described in option 4, we fail to see why this should not be the case under transfer pricing requirements to select the most appropriate method.

Option 5: Ensuring appropriate taxation of excess returns

This is a CFC measure, and should be considered in light of Action 3. In any event, it is not clear how such undefined ‘excess returns’ can arise after a proper application of the arm’s length principle including the new guidance developed under the BEPS project.
February 6, 2015

Mr. Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
Organization for Economic Cooperation and Development  
2, rue André Pascal  
75775 Paris  
FRANCE

Re: Comments on Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization, and Special Measures)

Dear Mr. Hickman:

We are pleased to submit comments on behalf of the transfer pricing professionals of Deloitte Tax LLP and Deloitte LLP regarding the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization, and Special Measures). We appreciate this opportunity to share our views on this issue and hope you find our comments valuable to the discussion.

We look forward to continued collaboration with the OECD on this and other transfer pricing initiatives.

Very truly yours,

DELOITTE TAX LLP
By: Todd Wolosoff  
U.S. Transfer Pricing Leader

DELOITTE LLP
By: Markus Navikenas  
Canada Transfer Pricing Leader

---

1 Deloitte LLP and Deloitte Tax LLP are member firms of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (DTTL). DTTL and each of its member firms are separate and distinct legal entities. DTTL itself does not provide professional services of any kind. Please see www.deloitte.com/about for a detailed description of DTTL and its member firms.
DELOITTE COMMENTS ON OECD’S DISCUSSION DRAFT ON BEPS ACTIONS 8, 9, AND 10: REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERIZATION, AND SPECIAL MEASURES)

EXECUTIVE SUMMARY

Deloitte’s Global Transfer Pricing practice supports the use of the arm’s length principle as the only viable standard to allocate profits earned by multinational enterprises (MNE), as does the OECD. We are concerned, however, that certain proposals in the discussion draft move away from the arm’s length principle, because they appear to be inconsistent with sound and settled economic analysis of how open markets function.

The following is a summary of the key points we believe need to be addressed in the discussion draft, and that are the subject of our comments:

- The discussion draft does not appear to be consistent with settled economic analysis of how markets price risk. We believe that as long as risk is appropriately priced, tax authorities should be indifferent to how related parties allocate risk.

- The discussion draft appears to place too little reliance on the terms of related-party contracts. The written terms of related-party contracts should be supplemented or disregarded only when the actions of the parties make it impossible to respect those terms.

- The risk/return trade-off is grounded in fundamental, sound, and settled economic principles and must be respected to maintain the integrity of the arm’s length principle.

- The discussion draft’s discussion of moral hazards suggests that substantial value accrues to the management of risk. Management of risk is generally available in the market place and garners no more than a routine investment return\(^2\) in most situations.

- We agree that control of risk is important in determining who should bear risk. However, between unrelated parties, control is exercised by aligning the parties’ incentives, and through the controlling party’s ability to hire and fire the risk manager.

- We are concerned that many of the examples in the discussion draft are factually incomplete and thus could be misinterpreted.

---

\(^2\) We define a routine investment return as one for which reliable market benchmarks are available.
The OECD has proposed significant and wide-ranging changes to the transfer pricing rules and other rules affecting international transactions to eliminate the potential for base erosion and profit shifting (BEPS). The OECD should wait to see how effective these actions are in eliminating BEPS, before considering special measures outside the arm’s length principle.
THE ARM’S LENGTH PRINCIPLE

We begin our comments with a brief overview of the fundamental economic principles that are the foundation of the arm’s length principle for the pricing of transactions between associated enterprises. This overview of the use of the arm’s length principle follows the guidance provided by the OECD in its *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* since 1995; it also follows the guidance provided by the United States Treasury Regulations under United States Internal Revenue Code Section 482.

Attached is a Technical Appendix that contains a much deeper and more detailed discussion of these fundamental principles. We then proceed with a discussion of the December 2014 proposed changes to the guidance provided by the OECD in Chapter I of the Discussion Draft.

Any and all transfer pricing problems stem from the fact that associated enterprises enter into transactions among themselves outside of the forces of the open market (that is, within the MNE). Transactions that take place in the open market are subject to the competitive forces of supply and demand. These forces ensure that transactions that entail equal risks have the same *ex-ante* expected return. This fundamental principle of how markets function is referred to in economics as the Law of One Price. Without the Law of One Price markets would be riddled with arbitrage opportunities—trading strategies that have zero probability of losing money, positive probability of making money, and require zero initial wealth.

For example, consider equally risky investments A and B. Suppose the *ex-ante* expected return of investments A and B is 10 percent and 15 percent, respectively. Rational investors would all select investment B because of its expectation of providing a higher return than investment A. The high demand for investment B will raise its price and decrease its expected return. The low demand for investment A will decrease its price and increase its expected return. These are the forces of the open market. The Law of One Price says that these forces will result in investments A and B having the same expected return. At that point, the market for the level of risk of investments A and B will be clear—supply and demand for each investment will be equalized. Any alternative investment available in the market, at the same risk level, will have the same *ex-ante* expected return as investments A and B. In other words, all other realistic alternatives to investments A and B will have the same expected returns.

In short, the arm’s length principle states that the pricing of a transaction that took place outside the forces of the open market between associated enterprises will be respected if consistent with the pricing that would have emerged if the forces of the open market applied to that transaction. Applying this principle to associated enterprises means that if a transaction between associated enterprises carries the same level of risk as investments A and B in our example above, the price used by the associated enterprises will be respected if it results in the same *ex-ante* expected return.
as investments A and B—the Law of One Price is applied to the pricing of the transaction between associated enterprises.

The guidance provided by tax authorities to help taxpayers apply the arm’s length principle to their transactions is thus mostly guidance on how to most appropriately (in the case of the OECD) or most reliably (under the U.S. regulations) obtain a measure of the one price that emerges from the forces of the open market for a given level of risk. This measurement exercise can be challenging, because:

- Risk is not directly observable; the realization of risk (ex-post) may or may not be reflected in accounting statements;
- *Ex-ante* expected returns are not directly observable, whereas prices and *ex-post* returns generally are; and
- Most (not all) measures of market returns are based on accounting statements, and are thus merely *ex-post* proxies for true *ex-ante* expected market returns.

Because risk is not directly observable, the guidance provided by the OECD and the United States has been to (i) use the written contract as the starting point of the transfer pricing analysis and the application of the arm’s length principle. The written contract allocates the risks involved in a transaction between the parties to that transaction; (ii) complement and refine the understanding of the allocation of risk emerging from the analysis of the written contract by analyzing the assets used, functions performed, and cost structures (fixed versus variable costs) required by both parties; and (iii) find comparable transactions (transactional benchmarking) or comparable companies (comparable benchmarking) operating under the forces of the market to obtain the most appropriate (OECD) or most reliable (United States) measure of an arm’s length result (Law of One Price). The word “comparable” in this context ultimately refers to risk. The comparable transactions or companies used as benchmarks must be exposed in their open market dealings to comparable risks as the associated enterprises in their dealings within the MNE.

The Law of One Price, and thus the arm’s length principle, results in a unique price emerging from the forces of the open market, for an investment or transaction of any given risk level. This mapping from risk to a single price is called the “efficient risk-expected return frontier.” It exists because of the Law of One Price.³ Without the Law of One Price, none of the guidance provided by the OECD or the United States in connection with benchmarking would make sense—multiple prices could and would be found for the same transaction, at the same level of risk, with the same use of assets, performance of functions, and cost structures, depending on which benchmarks are used. Thus, there would not be an objective principle that could be objectively applied to determine transfer prices or to arbitrate controversy. More importantly, it would

³ See the Technical Appendix for a deeper and more technical discussion of the Law of One Price, the efficient risk-expected return frontier and how these economic concepts relate to the arm length principle.
imply the survival of arbitrage opportunities in the open market—a violation of the very principle of open market competition.

CONCLUSION

The previous section laid out the basic framework embraced by the OECD in the transfer pricing guidelines and by the United States Treasury Regulations under Section 482. The application of the arm’s length principle requires a comparability analysis that is at the heart of a meaningful benchmarking exercise of specific points on the efficient risk-expected return frontier. The existence of the frontier is the result of competitive forces in the market place and the Law of One Price. Taxpayers and tax authorities, when applying the arm’s length principle, are required to assess the pricing used between associated enterprises in a transaction by reference to open market outcomes on the efficient risk-expected return frontier, at the level of risk implied by the written contract, the assets used, the functions performed, and the cost structures of the parties to the transaction.

We will use this general framework extensively to provide our comments in connection with the proposed changes in the discussion draft.

DELOITTE RESPONSES TO SPECIFIC OECD REQUESTS FOR COMMENTS

RESPONSE TO “ADDITIONAL POINTS"

On page 13 of the discussion draft, the OECD requested input with as follows: “In summary, the issues tend to involve the extent to which associated enterprises can be assumed to have different risk preferences while they may also in fact be acting collaboratively in a common undertaking under common control.”

Associated enterprises acting collaboratively in a common undertaking under common control will almost always use different assets, perform different functions, and exploit productive technologies that involve different cost structures (fixed versus variable costs) that, at arm’s length, result in different mix of risk-expected return. The arm’s length principle requires taxpayers to demonstrate that each associated enterprise’s mix of risk-expected return is on the efficient risk-expected risk-return frontier. Acting collaboratively in a common undertaking under common control does not mean that each associated enterprise is economically one entity.

The specific points on the efficient risk-expected return frontier at which associated enterprises will end up depend on:

- The contractual allocation of risk agreed to by the parties; and
- The risk associated with the assets used, functions performed, and cost structures exploited by each party.
It would thus be a violation of the arm’s length principle to restrict the points on the efficient risk-expected return frontier available to associated enterprises by:

- Imposing contractual terms forcing all members of an associated enterprise to be located at the same point of the efficient risk-expected return frontier; and
- Denying contractual terms or transactions between associated enterprises that result in placing them at different points of the efficient risk-return frontier.

It would be a violation of the arm’s length principle because all points on the efficient risk-expected return frontier are, by definition, arm’s length—they all result from the Law of One Price that governs the outcomes in the open market.

RESPONSES TO RISK-RETURN TRADE-OFF QUESTIONS

The OECD requested responses to a number of questions directly related to the conceptual framework of the transfer pricing guidelines. Our responses to those questions are consistent with the application of the arm’s length principle outlined above, and the guidance provided by the OECD since 1995 in the application of the arm’s length principle.

**Question 4 at page 14:** Under the arm’s length principle, should transactions between associated enterprises be recognized when the sole effect is to shift risk? What are examples of such transactions? If they should be recognized, how should they be treated?

No transaction, whether between associated enterprises or not, has the sole effect of shifting risk. Transactions always involve obligations and promises of cash outflows and cash inflows, and associated uncertainty. For example, a contractual agreement by a principal to provide a contract manufacturer with a cost-plus reimbursement on actual financial results rather than on projected financial results is a transaction that results in (i) an incremental obligation of cash outflows from the principal to the contract manufacturer, should the actual third-party raw material costs of the contract manufacturer exceed the projected costs; (ii) an incremental promise of cash inflows to the principal from the contract manufacturer, should the actual third-party raw material costs of the contract manufacturer be less than the projected costs; and (iii) an increase in the market-correlated risk of the principal (that is, an increase in the cost of capital) and a corresponding decrease in the market-correlated risk of the contract manufacturer (a decrease in the cost of capital) because of the transfer of all fixed costs of the contract manufacturer to the principal. It would thus be incorrect to characterize this contractual arrangement as having the sole effect of shifting risk. This contractual arrangement profoundly changes the expected distribution of cash flows of each party; it also changes the uncertainty (including the market-correlated risk) of these cash flows. The expected cash flows associated with the two distinct contracts—one

---

providing a cost-plus reimbursement on projected financial results and one providing a cost-plus reimbursement on actual financial results of the contract manufacturer are two distinct assets that have a different stream of expected cash flows associated with them for each party. In addition, the discount rate that should be used to discount these expected cash flows would also differ when pricing one contract versus the other at arm’s length. This is the result of the difference between the two contracts in the party obligated to assume the manufacturing fixed costs.

Under the arm’s length principle, transactions that have economic substance—that is, they involve the transfer of a meaningful economic quantum that is traded in the market place (contract, assets, fixed costs), result in a reallocation of risks that are priced by the open market, and should therefore be recognized and priced under the arm’s length principle (Law of One Price).

The very existence of the efficient risk-expected return frontier that forms the basis and the foundation of the application of the arm’s length principle implies that any movement along that frontier should be respected because it involves a fair exchange of risk-adjusted value. Reciprocally, transactions involving movements outside the efficient risk-expected return frontier should be priced back to the efficient risk-expected return frontier.

Examples of transactions along the efficient risk-expected return frontier are plentiful in the market place—in fact, all open market transactions involve movements along that frontier; that is the whole point of the Law of One Price. Third-party investors have the freedom to locate themselves on that frontier wherever they want, and can freely move from one point to another through open market transactions, without having to explain their movement to other market participants. Free competitive markets are very similar to democracies—there is freedom of movement and choices. This principle of freedom is at the very heart of free competitive markets.

Applying the arm’s length principle to associated enterprises as the objective standard by which they will be judged by tax authorities, but denying them the freedom to locate themselves anywhere they see fit on that frontier by the arbitrary truncation of possible outcomes on the frontier is fundamentally inconsistent with the arm’s length principle.

**Question 5 at page 15:** In the example at paragraphs 90 and 91, how does the asset transfer alter the risks assumed by the two associated enterprises under the arm’s length principle?

The asset transfer results in the shift of the obligation by S1 to fund costs (associated with the maintenance and enhancement of the trademark) to S2. Costs associated with the maintenance and enhancement of intangible assets are economic fixed costs -- they create what economists call “operating leverage.” Fixed costs, and thus operating leverage, magnify the market-correlated risks of whoever is obligated to fund them.5

---

The example thus depicts a case in which the cost of capital of S1 decreases, not as the result of the asset transfer, but as the result of the funding obligation transferred along with the asset from S1 to S2. Reciprocally, and for the same reason, the cost of capital of S2 increases. This is a meaningful shift of market-correlated risk from S1 to S2 that is priced by the open market as a movement along the risk-expected return frontier. We provide further extensive discussion of this example later in our comments.

**Question 6 at page 15:** In the example at paragraphs 90 and 91, how should risk-return trade-off implications be taken into account under the arm’s length principle?

The movement along the efficient risk-expected return frontier should be measured by applying the realistic alternative concept as follows. S1 would not agree to the transaction if it were not at least as well off (i) operating with the ownership of the asset and the funding obligation (resulting in a greater cost of capital) to maintain and enhance the asset; versus (ii) operating without the ownership of the asset but relieved of the funding obligation (resulting in a lower cost of capital). S2 would not agree to take on the funding obligation (and face a greater cost of capital) if it were not at least as well off as when operating without the funding obligation (and face a lower cost of capital). The shift in expected return from S1 to S2 required to achieve indifference by both parties on a risk-adjusted basis (along the frontier) can thus be easily calculated after an arm’s length measurement of the impact of the size of the funding obligation on the cost of capital of the two parties has been measured.\(^6\)

**Question 7 at page 15:** Under the arm’s length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk? If so:

a) Are there limits to the extent that the risk-return trade-off should be applied? For example, can the risk-return trade-off be applied opportunistically in practice to support transactions that result in BEPS (for example by manipulating the discount rates to “prove” that the transaction is economically rational)?

Transactions that (i) have economic substance; (ii) involve meaningful exchanges of risk-adjusted value through meaningful changes in expected cash flows; and (iii) are priced correctly should be respected. The open market and its functioning (i.e., the arm’s length principle) allows investors to freely locate themselves wherever they want on the efficient risk-expected return frontier, for whatever reasons they want to. Limiting associated enterprises’ access to truncated portions of the efficient risk-expected return frontier, while at the same time asserting the arm’s length principle as the objective standard that applies in all cases, is akin to claiming free movement of labor in the

---

European Union but arbitrarily restricting access to a few specific member countries (for example, “there is free movement of labor within the European Union, but you cannot go to France and the United Kingdom”). Tax authorities, like arm’s length parties, should be indifferent to this action, because ex-ante risk-adjusted returns are, by definition of the efficient risk-expected return frontier, the same.

Transactions priced through “manipulation” of the market benchmarks used to estimate the location of the efficient risk-expected return frontier (a discount rate in that context is a market participant benchmark) should be adjusted and re-priced using an appropriate discount rate.

b) Are there measures that can be taken in relation to the risk-return trade-off issue to ensure appropriate policy outcomes (including the avoidance of BEPS) within the arm’s length principle, or falling outside the arm’s length principle?

Any measure taken to limit the ability of MNEs to select at which points on the efficient risk-expected return frontier they locate their various legal entities will fall outside the arm’s length principle, by definition of the arm’s length principle. Any market participant has the freedom to locate itself at any point on the efficient risk-expected return frontier without having to justify to the market or to the other market participants (including tax authorities) the reasons why one point on the frontier is selected versus other points—all points have same ex-ante risk-adjusted value. That also means tax authorities should be indifferent between collecting higher expected taxes that are riskier, versus collecting lower expected taxes that are less risky, because on a risk-adjusted basis both have the same ex-ante value. At arm’s length the same freedom is provided to associated enterprises.

Question 8 at page 15: Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in proposed guidance?

The above analysis, including the Law of One Price, applies to any and every transaction that takes place under the forces of competitive markets. Risk is the core engine of expected return in any and all transaction taking place in the open market. There are no meaningful differences in the way market forces apply to financial services transactions, tangible transactions, intangible transactions, or non-financial services transactions. The forces of the open market are universal (hence the use of the word “Law” in Law of One Price). The “invisible hand” of Adam Smith was not predicated on any specific transaction or industry. The Law of One Price does not selectively apply to any specific
transaction or industry; it applies equally to all, as long as competitive market forces are allowed to do their work.

Asserting that risk affects expected returns differently for some types of transactions than others, or for some industries than others would imply (i) existence of arbitrage opportunities, because investors could short the transaction that has lower expected return at a given level of risk and long the transaction that has greater expected return at the same level of risk; (ii) the existence of significant frictions in the open market that would prevent the arbitrage opportunities to be competed away. Investors do not care whether they transact in financial assets, tangible assets, contracts, or any other instrument to achieve their overarching goal of profit maximization. As long as the open markets provide them access to all of those tools, they will use them and exploit any arbitrage opportunity they can spot. The forces of the open market have the same predictable results as the gravitational pull of the earth on any object of any mass dropped anywhere in the world -- it will fall -- regardless of the specific market, transaction, or industry to which those forces apply.

RESPONSES TO “MORAL HAZARD” QUESTIONS

The OECD has requested comments in connection with the role that the concept of moral hazard plays in the context of transactions between associated enterprises. We welcome the recognition by the OECD that moral hazard plays an important role in arm’s length transactions between unrelated parties. We particularly welcome the statement that “The concept extends to the safeguards or incentives that unrelated parties may incorporate into contracts between them in order that interests are better aligned and moral hazard is reduced or avoided.” [“Moral Hazard” at page 14]

However, we are concerned that the OECD is suggesting that third parties would avoid entering into transactions when the risk-bearing party does not manage risk, i.e., transactions that involve moral hazard, and using that suggestion to imply that therefore at arm’s length associated enterprises should not be allowed to enter into transactions in which the risk-bearing party does not manage risk.

We object to this interpretation of the vast economic literature that exists on moral hazard. Although it is true that the first exploration of moral hazard in the context of the insurance industry concluded that “because a person who carries insurance will be more careless because of being insured, insurance companies should not provide full insurance,” that is very old and dated literature. The much more recent economic literature on moral hazard is positive and seeks to explain why it is that we observe transactions whereby the risk-bearing party is not the risk-taking party.7

Economists have thus long recognized that third-party transactions often involve asymmetrical information between the risk-taking party and the party managing risk. For a moral hazard to occur, the following conditions must exist:

- An agent must be empowered to act on behalf of a principal;
- The agent must have more information than the principal about his or her actions and intentions;
- The principal cannot completely monitor the actions or intentions of the agent, and cannot perfectly infer from the consequences of the actions of the agent what actions the agent took;
- The interests of the principal and the agent are not perfectly aligned, resulting in the agent having an incentive to take actions that are not in the best interest of the principal; and
- The principal (risk bearer) bears the risks of the consequences of the actions taken by the agent (risk taker).

The extensive economic literature on principal-agent problems and mechanism design provides insights into how third parties use contracts to alleviate moral hazard issues. The genesis of that literature was the observation that third parties routinely enter into transactions where the party bearing the risks (principal) is not the party managing the risk (agent), and is unable to observe or infer from the realization of the risk (impossibility to monitor) whether it was caused by randomness or by the agent’s actions.

Given the overwhelming recognition in the economic literature, and real world experience, that at arm’s length we regularly observe the risk-bearing party not managing the risks it is exposed to, and given that the arm’s length principle applies to assess transactions between associated enterprises, consistency in the guidance provided should make it clear that economic substance does not require the associated enterprise bearing risk in a transaction with another to manage that risk. Arm’s length parties will always control the risk by being capable of entering into the contract that results in the separation of risk-bearing and risk-managing, and by retaining the ability to hire and fire the risk-taking party. Open market transactions, by definition, have economic substance and are arm’s length.

Because of that observation, we urge the OECD to clarify the guidance provided in Paragraph 78 at page 24. We agree with the statement below that if the words “control risk” are defined as the ability to enter into the contract that results in the separation of bearing risk and managing risk, and the ability to hire and fire the party that will be the risk-managing party. We are concerned that the definition of “control over risk” provided by the OECD in Paragraph 39 at page 13 and further elaborated upon in Paragraph 55 at page 19 is close to the definition of “risk management” provided in Paragraph 55 at page 19. We are thus concerned that tax authorities could read the statement below as equivalent to saying, “A party that does not manage risk will not be allocated the risk and therefore will not be entitled to unanticipated profits (or required to bear unanticipated losses).” Paragraph 78 at page 24 reads:
“A party which does not control risk will not be allocated the risk and therefore will not be entitled to unanticipated profits (or required to bear unanticipated losses).” [Par. 78 at page 24]

**Question 1 at Page 14:** Under the arm’s length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?

This question appears to assume that unrelated parties would not enter into contracts in which they cannot control and manage risk. As discussed above in the general discussion of moral hazard, there are numerous situations at arm’s length in which unrelated parties enter into contracts in which they control, either by deciding whether to enter into the transaction or hiring and firing the risk manager, but do not manage the risk. Please see the discussion below concerning risk management and control of risk, in which we observe that risk management is a routine function that can be reliably priced. We also note, as discussed below in reference to Paragraphs 90 and 91 that there are numerous situations at arm’s length by which as a result of the nature of the transaction the parties’ incentives are aligned. Therefore, we do not think it is necessary to impute moral hazard and contractual incentives in most situations.

**Question 2 at Page 14:** How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?

We do not disagree with the concern expressed in that question and in Paragraph 67. However, the arm’s length principle is much more of an objective principle when applied to value transactions than it is when evaluating actions and behaviors of companies (i.e., would third parties enter into that transaction in the first place?). The United States Treasury Regulations under Section 482 address that issue in Treas. Reg. §1.482-1(d)(3)(ii)(B) and Treas. Reg. §1.482-7(1)(d)(3)(iii)(B) by saying that if associated enterprises enter into a transaction with a written contract before or at the time of the transaction, and the written contract has economic substance, then the contract must be priced regardless of whether or not third parties would enter into the transaction, and whether or not the transaction is observed in the market place (there is a significant difference between not observing a transaction in the market place and asserting that third parties would not enter into a transaction). There is no question that associated enterprises enter into certain transactions that third parties would not enter into absent any tax considerations. Ruling these transactions out as nonpermissible, or disregarding the terms of these transactions and imputing arbitrary terms to them because of tax considerations and BEPS could result in disregarding many intercompany transactions that do not involve BEPS and may significantly impede MNEs’ ability to function. We believe the OECD should consider guidance similar to that provided in the United States Treasury Regulations noted above.
**Question 3 at Page 14:** In the example at paragraph 90 and 91 how should moral hazard implications be taken into account under the arm’s length principle?

The first step in the application of the arm’s length principle is to analyze the incentives of the licensor and of the licensee as individual profit-maximizing persons, rather than as group profit-maximizing persons. In that example, the licensor S2 arguably collects a royalty based on sales from S1. S2’s profits are thus a function of the size of S1’s sales, and of the costs S2 has to fund for the maintenance and enhancement of the trademark. We note that this function is performed by S1. S1’s profits, in turn, are a function of S1’s sales, operating costs, and S1’s revenue from S2 derived from the maintenance and enhancement of the trademark. The alignment of interests between S1 and S2 is almost perfect; both companies’ profits depend on the size of S1’s sales, which in turn depends on successful maintenance and enhancement of the trademark. S1 may have an incentive to overspend on these maintenance and further enhancement of the trademark activities if compensated on a cost-plus basis. This is easily taken care of by S2 monitoring and controlling the activities of S1. The example made it clear that S2 has able personnel to do that. The moral hazard issue related to these development activities is minimal, because monitoring is easy to do. We do not believe the example at Paragraphs 90 and 91 involves any significant moral hazard issue.

**Concluding Thoughts on Moral Hazard**

We welcome the acknowledgment in the vast economic literature dealing with moral hazard that at arm’s length the risk-bearing party to a transaction is routinely not the risk-taking party, but it always is the risk-controlling party. The logical conclusion of the application of the arm’s length principle is thus that associated enterprises should be allowed to enter into transactions whereby one legal entity manages risks without bearing the consequences of the risk, if that is the intent of the parties and as long as the risk-bearing party controls risks (ability to enter into the transaction and hire and fire the risk-taking party).

**DELOITTE COMMENTS ON NEW GUIDANCE**

**REALISTIC ALTERNATIVES**

Paragraph 12 at page 7 of the transfer pricing guidelines (proposed December 2014) states:

“*Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a better opportunity to meet their commercial objectives.*” [Par. 12 at page 7]
In the context of the application of the arm’s length principle to a transaction between associated enterprises, a correct comparability analysis and benchmarking exercise (valuation) in reference to open market outcomes ensures that the principle outlined by the OECD in Paragraph 12 at page 7 is verified. This is because the efficient risk-expected return frontier aggregates all realistic alternatives into one single price at any level of risk (see Figure 4 and the Properties of the Efficient Risk-Expected Return Frontier in our Technical Appendix).

Although we understand the reasons for the guidance provided in Paragraph 12, we are concerned that tax authorities may interpret the language of Paragraph 12 as requiring a taxpayer to demonstrate that a transaction entered into between associated enterprises offered the best opportunity to meet its commercial objectives, better than any other realistically available alternative transaction, even though the alternative transaction may involve different business judgments and possibly different functions than those contemplated by the transaction being reviewed. We believe the realistic alternative criteria should be limited to an alternative transaction in which the functions of the parties are the same but the risks are different. For example, a manufacturer has the alternative of selling products to a related distributor under terms whereby the distributor bears the cost of promoting and developing the market or the manufacturer bears the cost of promoting and developing the market. Similarly, the owner of technical intellectual property has the alternative of licensing the property to a manufacturer under terms whereby the manufacturer has the obligation to further develop the intellectual property or the licensor has the obligation to further develop the intellectual property. However, in determining the price of products to be sold or the license payments, taxpayer and tax authorities should not consider whether entering into a completely different business arrangement such as a joint venture with an unrelated company that has already developed the market for similar products in the case of the distributor or has synergistic intellectual property in the case of the license is a better realistic alternative.

We therefore urge the OECD to clarify the language in Paragraph 12 at page 7 to avoid any misinterpretation of the guidance by taxpayers and tax authorities, and to reaffirm that a proper application of the arm’s length principle (following the valuation guidance provided in subsequent chapters of the transfer pricing guidelines) will result in satisfying the realistic alternative concept.

**IDENTIFYING COMMERCIAL AND FINANCIAL RELATIONS**

Paragraph 5 at page 5 of the transfer pricing guidelines (proposed December 2014) states:

“It should not be automatically assumed that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties.” [Par. 5 at page 5]

Paragraph 5 at Page 5 concludes with the following guidance:
“Where there are differences between contractual terms and factual substance, the conduct of the parties in their relations with one another, and what functions they actually perform, the assets they actually employ, and the risks they actually assume and manage, in the context of the consistent contractual terms, should ultimately determine the delineation of the actual transaction.” [Par 5. at page 5]

The OECD offers several examples to illustrate how written contractual terms could or should be clarified, supplemented, or just disregarded. These examples can be found in Paragraph 4 at page 5, Paragraph 6 at page 5, and Paragraph 8 at page 6. We provide extensive comments for most of the examples contained in the discussion draft in the section entitled “Concerns with Certain Examples and Certain Statements.”

The importance of the written contract as the starting point of any transfer pricing exercise was emphasized in our discussion of the arm’s length principle (see The Arm’s Length Principle section and the Technical Appendix). We welcome the language in Paragraph 2 at page 4 that states:

“The process of identifying the commercial or financial relations between associated enterprises follows from examining contractual terms governing those relations together with the conduct of the parties.” [Par. 2 at page 4]

However, we are concerned that the language in Paragraph 5 at page 5, and more specifically this phrase, “Where there are differences between contractual terms and factual substance, the conduct of the parties... should ultimately determine the delineation of the actual transaction” (our emphasis) is too strong and could be interpreted by tax authorities as a license to disregard written contracts that are incomplete, have ambiguous provisions, or are silent on certain elements of the transaction that could be immaterial or irrelevant to the ability to price the contract.

Complete contracts are difficult to write (see Technical Appendix). It is extremely rare to address every possible contingency in a given contract. This applies to contracts between associated enterprises and between third parties. In addition, contracts are legally binding documents that affect associated enterprises well beyond the tax laws. Tax authorities, when considering any changes to contracts, should thus exercise great care and restraint.

For all the reasons stated above, we believe the guidance provided by the OECD should emphasize that (i) every possible attempt should be made to price the contract as written and agreed upon by the parties; (ii) tax authorities should be allowed to attempt to clarify or supplement the contract based on economic substance (the behavior of the parties) only when the contract cannot possibly be priced because of incompleteness and ambiguities or inconsistent actions by the parties in prior years that fundamentally change the relationship between the parties; and (iii) only in extreme cases should the tax authorities be allowed to disregard a contract and rewrite it.

We believe the guidance provided by the OECD should favor, as much as possible and to the full extent possible, adjustments to the price of transactions (valuation) over
attempts to rewrite portions of the contract to achieve an allocation of risk consistent with the pricing (see Figure 5 and associated discussion in the Technical Appendix). In both instances, most of what could possibly be respected in the contract should be respected. The bar for tax authorities to disregard and completely rewrite a contract, and therefore select an entirely new (and arbitrary) point of risk-expected return on the efficient risk-expected return frontier, should be extremely high, and such rewriting should be allowed only in egregious cases.

GUIDANCE ON RISKS

Close to 50 additional proposed paragraphs on risks were added to the transfer pricing guidelines in the discussion draft under Section D.2. Ironically, one of the most fundamental and profound statements about risk in all of Chapter I is to be found in Paragraph 22 at page 9 under Section D.1 rather than under Section D.2:

“Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realized.” [Par. 22 at page 9]

Additionally, Paragraph 36 at page 12 reads:

“Risk is inherent in commercial activities. Businesses undertake commercial activities because they seek opportunities to make profits, but those opportunities carry uncertainty that the required resources to pursue these opportunities will not generate the expected returns.” [Par. 36 at page 12]

Another example of such language can be found in Paragraph 41 at page 15:

“No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return.” [Par. 41 at page 15]

As discussed earlier, the relationship between risk and expected return is at the heart of the application of the arm’s length principle; it is pervasive throughout the guidance provided by the OECD in connection to comparability assessments for benchmarking purposes and benchmarking (see the Arm’s Length Principle section). For example, the revised valuation guidance provided by the OECD in the consensus revisions to Chapter VI of the transfer pricing guidelines of September 2014 expanded significantly on how to measure the relationship between risk and expected return using discounted cash flow (DCF) methodologies. The other, more traditional methods of assessing the level of expected returns provided by the open market, such as the transactional net margin method (TNMM), the comparable profit method (CPM), or the comparable uncontrolled price method (CUP), for example, all start with an assessment of the risks involved (by reference to the written contract and through a functional analysis) followed by a mapping of the asserted level of risk into an open market measure of expected or realized returns. The goal of achieving consistency in the guidance provided in Chapter I
with the guidance provided in other key chapters of the OECD transfer pricing guidelines (for example, Chapter VI and Chapter IX) will inform our comments.

Because not all risks are created equal and not all risks are priced in the open market, we welcome the provision of additional guidance to help taxpayers and tax authorities understand, analyze, and price risks consistently with how the open market prices risks—that is the mandate of the arm’s length principle.

Businesses, investments, projects, transactions, whether involving financial assets or real assets all have one critical thing in common -- they involve obligations and promises of expected cash outflows and cash inflows, or they affect the obligations and promises of cash outflows and cash inflows of other assets (e.g., derivative assets and contractual provisions such as collars). These expected cash outflows and cash inflows are uncertain—they are subject to volatility. Some of that expected volatility can be managed, some cannot. Some of that volatility is priced by the open market, some is not. A significant portion of the discussion provided by the OECD under Section D.2 of the discussion draft addresses the management of risks and the control over risks.

What Risks Are Relevant For Transfer Pricing?

Paragraph 42 at page 16 concludes with the sentence, “Risks which are vaguely described or undifferentiated will not serve the purpose of a transfer pricing analysis seeking to delineate the actual transaction and the actual allocation of risk between the parties.”

Paragraph 42 proceeds to list and broadly define the following categories of risks as being relevant to a transfer pricing analysis. These risks are:

- Strategic risks or marketplace risks;
- Infrastructure of operational risks;
- Financial risks;
- Transactional risks; and
- Hazard risks.

Because specific risks may be relevant to a transfer pricing analysis only to the extent that they are priced in the open market, the following statement in Paragraph 42 at page 16 should be considered along with the categories of risks relevant to a transfer pricing analysis listed above: “On the contrary, the ability of a company to face, respond to and manage externally driven risks is likely to be a source of competitive advantage and sustained returns over the long term.”

We strongly disagree with the previous assertion. The ability of a company to face, respond to, and manage externally (and internally) driven risks is a necessary condition for a business to remain a going concern in the open market. Competitive labor markets supply qualified professionals that perform risk management functions for the companies that hire them. The value of the risk management functions performed by risk managers is reflected in the compensation of these individuals. Competition for risk
management talent ensures that no company operating in the open market can obtain a permanent (or sustained) competitive advantage reflected in a premium return for that function. If that were the case, other companies would compete and bid up the compensation of the risk management talent until the full premium of the return is captured in the compensation of the risk managers. We urge the OECD to remove from the guidance the suggestion that the mere fact that a company performs risk management functions could entitle that company operating in the open market (application of the arm’s length principle) to an accretion of value in excess of what is paid to risk managers—unless some unique intangible asset used in risk management can be identified through a functional analysis and priced.

Going back to our attempt at identifying risks priced by the open market, we first note that the relationship between risk and expected returns noted by the OECD in Paragraphs 22, 36, and 41, for example, did not distinguish one category of risks from another (for example, categories listed in Paragraph 42). These statements appear to apply and hold true for all risks. We also note that in the open market investors cannot directly trade risks for expected returns—investors trade risks for expected return by trading underlying economic quanta such as assets, contractual obligations, or fixed costs that affect the size and the volatility of cash flows. In other words, investors trade assets, contractual obligations, or fixed costs to move along the efficient risk-expected return frontier of Figure 6 (note: our numbering of the figure follows the numbering of figures in the Technical Appendix):

**Figure 6: Moving Along the Efficient Risk-Expected Return Frontier**

Consider a company located at “Starting Position” in Figure 6. Suppose the company decides to buy or sell assets, contractual obligations, or fixed costs in such a way that its level of risk decreases to that of the “Ending Position.” Because the transactions took place in the open market, the efficient risk-expected return frontier tells us three important things:

1. The expected return dictated by the open market at “Ending Position” is such that the company is *ex-ante* indifferent between the risk-expected return mix of “Starting Position” and “Ending Position”—both locations have the same risk-adjusted value.
2. The statement above holds true regardless of whether or not risk management functions or risk controlling functions are performed—these may affect the ability of the company to *ex-post* realize the expected returns promised by “Beginning Position” and “ending Position,” but the open market does not provide a premium *ex-ante* return for performing risk management or risk control functions—competitive markets ensure that companies do perform these functions competently.

3. When considering two realistic alternative opportunities located on the efficient risk-expected return frontier, one of known value and the other of unknown value, one can be priced by reference to the value of the other. This is often the valuation along the efficient risk-expected return frontier done when restructuring a full-risk entity into a limited-risk entity.

Item 2 above is a consequence of the Law of One Price discussed earlier (see the Arm’s Length Principle section). Competition ensures that if two opportunities, at the same level of risk, are offered in the open market, one of which offers competent risk control and management and the other one does not, the one with the lower expected return (because of a lack of competent risk control and management) will be priced out of the market—no rational investor will invest in that opportunity. Competent risk control and management does not result in a market premium; the lack thereof results in being priced out of the market. However, since competent risk management is widely available in the market without a premium, it should be assumed that both related parties and unrelated comparables can readily obtain competent risk management. In that context, a premium return is defined as a return above and beyond the normal competitive return provided by the open market that does not get competed away because of the existence of barriers to entry.

We believe it would be helpful for the guidance provided in Chapter I to move away from suggesting that individual risks can be isolated and priced separately from the cash flows they are attached to, because individual risks are not directly traded in the open market and are not directly observable. The guidance should focus instead on a careful functional analysis of the interaction of all the risks that are priced in the market (the market-correlated risks) in reference to the assets, contracts, and cost structures involved. That guidance would then be consistent with the valuation guidance provided in other chapters of the transfer pricing guidelines, including Chapters VI and IX.

**Risk Management and Control Over Risks**

Paragraph 55 at page 19 sets out the three elements of risk management (the Roman numbering matches the OECD numbering on purpose):

i. The capability to make decisions to take on or decline a risk-bearing opportunity, together with the actual performance of that decision-making function;
ii. The capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and

iii. The capability to mitigate risk, that is, the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

Paragraph 39 at Page 13 sets out the elements of control over risk (no numbering is used on purpose):

- The capability to make decisions to take on the risk; and
- The capability to make decisions on whether and how to respond to the risk.

Paragraph 39 at page 13 proceeds with the statement: “Control should not be interpreted as being limited to the decision to adopt risk mitigation measures, since in assessing risks businesses may decide that the uncertainty associated with some risks after being evaluated, should be taken on and faced with little or no mitigation in order to create and maximize opportunities.” Moreover, Paragraph 55 at page 19 states: “Where a decision is made to outsource risk mitigation as described in (iii), control of the risk would require capability to assess, monitor, and direct the outsourced measures that affect risk outcomes, together with the performance of such assessment, monitoring, and direction.”

As discussed earlier, we believe that there exists a competitive labor market for capable risk management talent, and the value of such activity is thus known and easy to measure—it is a routine function commanding routine returns at arm’s length. We also observe from experience companies outsourcing in the open market routine risk management functions and companies performing routine risk management functions on behalf of other (uncontrolled) companies. Companies outsourcing these risk management functions retain ultimate control of the risks, since they can decide to terminate a risk manager or a company providing risk management services, and use the open market to find a suitable replacement.

For the reasons noted above, we are concerned about the statement in Paragraph 57 at page 20 that reads:

“The performance of risk management may have an important effect on determining arm’s length pricing between associated enterprises, and it should not be concluded that the pricing arrangements adopted in the contractual arrangements (see Section D.2.2) determined the respective contributions to risk management.” [Par. 57 at Page 20]

As discussed earlier, we believe that tax authorities should make every effort to price the contract as it was written by the parties. In addition, risk management functions are routine functions that are likely to be performed by carefully selected comparable companies. To the extent that risk management functions are split between legal entities, and consistent with our earlier observation, the value of risk management functions is appropriately estimated by reference to the return on costs earned by companies engaged in that activity, or by reference to the compensation of risk managers in the open market.
We are further troubled by the following statement, also in Paragraph 57 at page 20:

“For example, a manufacturer may claim to be protected from the risk of price fluctuation of raw material as a consequence of its being remunerated by another group company on a cost-plus basis that takes accounts of its actual costs. The implication of the claim is that the other group company assumes the risk. However, the key point to address is whether there exists an operational or financial risk associated with raw material price fluctuation and if so how that risk is managed in the business.” [Par. 57 at page 20]

We discussed in the preceding sections how rational investors move along the efficient risk-expected return frontier by trading assets, contractual provisions, or fixed costs. To the extent that the manufacturer in Paragraph 57 has operational fixed costs included in the cost basis subject to the cost-plus arrangement, the assertion that a cost-plus remuneration calculated on actual rather than projected costs decreases the manufacturer’s exposure to market-correlated risk is not only entirely correct, it requires a decrease in expected return along the efficient risk-expected return frontier at arm’s length to maintain the value. The party providing the cost-plus remuneration on actual rather than projected costs will be subject to an increase in its market-correlated risks and will thus require an increase in expected return at arm’s length. This observation is true regardless of whether the management of the risk of raw material price fluctuation is performed in-house or outsourced to someone else for an arm’s length consideration.

The same issue is present in the analysis of the example in Paragraph 60 at page 20, and in the analysis of the example in Paragraph 91 at page 27. In the latter example, associated enterprises S1 and S2 enter in a transaction whereby S2 purchases the valuable trademark of S1 and finances the maintenance and enhancement of the trademark. All management functions related to the maintenance and enhancement of the trademark, as well as all functions related to the exploitation of the trademark are performed by S1 under the capable supervision and control of personnel of S2. The discussion in Paragraph 91 reads:

“Based on the facts as set out in this example, it is difficult to see how, if the parties were independent, S1 is afforded the opportunity to enhance or protect its commercial or financial position through the transactions. Company S1 is likely to have lost commercial value in that it no longer owns the trademark that is key in generating its income, and is subject to additional risk in that it is reliant on another party, Company S2, a company treated as independent under the arm’s length hypothesis, being willing to license the trademark to it and not to take actions which might enhance value for itself but potentially detract from Company S1.” [Par. 91 at page 27]

The discussion of the example omits that (i) the arm’s length purchase price of the trademark by S2, by definition of what an arm’s length price is, is of equal value as the expected (properly) discounted cash flows S1 could generate when not selling the asset and exploiting it itself—there is thus no loss in value for S1 at arm’s length; (ii) the incentives of S1 and S2 are naturally aligned—it is in both parties’ interest to maximize
the value of the trademark, because S2 collects royalties from S1; and (iii) S1 is no longer obligated to fund the fixed costs associated with the maintenance and enhancement of the trademark—S2 becomes obligated to fund these fixed costs. As discussed earlier, fixed costs affect the market-correlated risks of market participants. A more thorough analysis of this transaction provides the answer as to how S1 afforded the opportunity to enhance or protect its commercial or financial position through the transaction. The transaction removed from S1 the obligation to fund the maintenance and enhancement of the trademark—a fixed cost. As such, the market-correlated risk of S1 is lower after the transaction than before (i.e., lower cost of capital), and the market-correlated risk of S2 is greater after the transaction than before (i.e., higher cost of capital). Both S1 and S2 are moving with the transaction along the efficient risk-expected return frontier in opposite directions.

In addition, when agreeing to fund the fixed costs obligation of maintaining and enhancing the trademark, S2 offered an “engagement ring” to S1 in the sense that it put cash upfront to signal its credible commitment to S1 to make the right decisions to generate ex-post returns consistent with the increase in ex-ante expected return that is required by S2’s shareholders. This type of transaction is observed at arm’s length in the film and pharmaceutical industries, where studios and pharmaceutical companies routinely trade fixed cost obligations.

We are concerned that many of the examples provided by the OECD throughout Chapter I are not sufficiently developed factually and economically to provide useful guidance to taxpayers and tax authorities to assess real world situations. We are especially concerned about the possibility that tax authorities may improperly interpret this guidance as a basis for disregarding related-party contracts and ignoring legitimate transactions using as their authority some of the incompletely developed examples in the transfer pricing guidelines (proposed December 2014).

More specifically, we note that despite the well-known and established relationship between fixed costs and market-correlated risks, not a single reference appears in the OECD guidance on the importance of examining the cost structure of companies as an important determinant of risk allocation—i.e., that the proportion of fixed costs in the total cost structure of a company has much more impact on the market-correlated risk of the company (and therefore on the value of controlled transactions) than the nature of the functions performed by that company or the number of employees performing those functions. Yet we note that several examples provided in the guidance result in a transfer of fixed costs from one party to another—the impact of these transfers on the risk of each party is ignored, and thus the analysis is not consistent with the application of the arm’s length principle to these examples—the arm’s length principle provides that one should recognize the value the open market would assign to the increase in market-correlated risks resulting from the assumption of incremental fixed costs.
GUIDANCE ON NONRECOGNITION

According to Paragraph 82 at page 25, nonrecognition should occur only in the “exceptional circumstances the transaction as accurately delineated may be interpreted as lacking the fundamental economic attributes of arrangements between unrelated parties” [First sentence Par. 82 at page 25; our emphasis]. Moreover, “[U]nless the strict criteria for non-recognition set out in that section [referring to D.4; our addition] are met, the conclusion should be that the transaction as accurately delineated is recognized.” [Par. 82 at page 25]

We are concerned by the level of subjectivity that the guidance under D.4 provides. The use of the words “may be interpreted as lacking . . .” in Paragraph 82 at page 25 underscores that level of subjectivity. The arm’s length principle is an objective principle that provides a standard that can be applied without recourse to “interpretation”—one can argue how points on the efficient risk-expected return frontier are measured, but one cannot argue with the very existence of that frontier or its meaning (there is no room for “interpretation” of what it means).

As extensively discussed in our comments on “accurate delineation” (see the Realistic Alternative section and the Identifying Commercial and Financial Relations section), we believe the guidance, as currently written, would inappropriately allow tax authorities to easily ignore written legal contracts that have appropriate legal substance between associated enterprises within an MNE, without requiring the tax authorities to ever apply the nonrecognition guidance.

Any time a transaction is delineated by a tax authority in a manner that differs from the taxpayer’s intended delineation, as specified in its contracts, the outcome will be no different than nonrecognition or recharacterization—an arbitrary point on the efficient risk-expected return frontier will be imposed on the taxpayer by the tax authorities. We are concerned that the arbitrary point will be the point that maximizes the tax authorities’ non-risk-adjusted expected tax collection without regard for (i) the taxpayer’s intent; and (ii) the consequences of such arbitrariness on the taxpayer’s ability to seek and obtain relief from double taxation on the other side of the transaction.

We wish to express our concern that allowing tax authorities to make an interpretation that may deviate from the taxpayer’s legal transaction under the accurate delineation guidance effectively nullifies, and makes redundant, the nonrecognition guidance. This is problematic, as accurate delineation seems to be envisioned by the OECD as a common tool to be used by tax authorities, and without any of the intended safeguards against nonrecognition asserted by the OECD under Section D.4: “Unless the strict criteria for non-recognition set out in that section [referring to D.4; our addition] are
met, the conclusion should be that the transaction as accurately delineated is recognized.” [Par. 82 at page 25]

At arm’s length, a legally enforceable written contract would have the necessary substance to be recognized and respected as a binding, commercial agreement by both parties. The same threshold for recognition should be observed between associated enterprises in a transfer pricing analysis. Specifically, if both parties had the ability to enter into the contract in the first place, and have the rights and obligations noted in the contract, legal substance is present and deference to the contract by tax authorities should be required.

We urge the OECD to provide stronger guidance to limit the specific determination of deviations away from a taxpayer’s legally structured transactions, to require strict conditions to be met (clearly stating that every effort should be made to price the legal contract), and providing clear and objective safeguards against arbitrary deviations. We note that Paragraph 84 recognizes that “Associated enterprises may have the ability to enter into a much greater variety of arrangements than can independent enterprises, and may conclude transactions of a specific nature that are not encountered, or are only very rarely encountered, between independent parties, and may do so for sound business reasons.” [Par. 84 at page 25]

We agree.

Paragraph 89 attempts to provide a working definition of transactions exhibiting the “fundamental economic attributes of arrangements between unrelated parties,” noting that such arrangements would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted basis, compared to opportunities realistically available to them at the time the arrangement was entered into. The paragraph also notes that whether the MNE group as a whole is left worse off on a pre-tax basis is a relevant factor when considering the fundamental economic attributes test—we note that this principle will be nearly impossible to administer.

We are concerned about requiring tax authorities to assess the fundamental economic attributes of transactions between third parties, especially for those transactions that are not observed in the market place. There is an inherent significant level of subjectivity intrinsic to that counterfactual and typically there is no objective basis of comparison for the assessment—trained, experienced economists would probably often disagree as to what those fundamental economic attributes are. Tax authorities may also lack the specific business and industry expertise and knowledge to appropriately assess those fundamental economic attributes. Given the dire consequences of nonrecognition to taxpayers, we do not believe the OECD should provide the guidance in Paragraph 93. The resulting consequences for taxpayers may be controversy between countries that elect different counterfactual analyses without any objective arbitration standard, resulting in double taxation.
We note that many countries have adopted transfer pricing as an obligatory matter as part of the annual tax filing process, and apply stringent penalties to any taxpayer that does not comply. The OECD guidance on transfer pricing is used by many countries to interpret the correct application of transfer pricing and the arm’s length principle. Some countries, such as the United Kingdom, have adopted the OECD’s transfer pricing guidelines as an interpretive aid to domestic legislation. It is arguable that the uncertainty the guidance under D.1-D.4 would introduce, if adopted as currently drafted, and specifically in reference to the points discussed above, is incompatible with obligations under the European Convention on Human Rights, specifically insofar as providing the right to a fair trial and the right to have no punishment without certainty as to the law. If a conflict is confirmed, tax authorities would be left exposed to potential judicial challenges to their transfer pricing law in countries that have adopted legislation based on the European Convention on Human Rights.

Paragraphs 90, 91, and 92 proceed with the discussion of an actual example of the application of the guidance provided under Section D.4. We have provided an extensive discussion of this example in the section on “Risk Management and Control Over Risks,” and we incorporate those comments by reference in this section as well. We believe the example illustrates our very point—there is real danger of a transaction being subject to nonrecognition as a result of tax authorities missing a critical, fundamental economic attribute of the transaction under scrutiny. In the example in Paragraphs 90, 91, and 92, the OECD ignored the transfer of a fixed cost (the obligation to fund the maintenance and enhancement of the trademark) from S1 to S2, resulting in a decrease in the cost of capital of S1 and an increase in the cost of capital of S2. The OECD also ignored that if the consideration paid by S2 to S1 to acquire the underlying asset is really arm’s length (nothing in the example suggests otherwise), then, by definition, S1’s commercial and financial position is left unchanged on a risk-adjusted basis.

Finally, Paragraph 93 spells out the dire consequences of a nonrecognition event; the taxpayer’s structure for transfer pricing purposes is replaced by the alternative realistically available transaction asserted by the tax authorities to afford the parties the opportunity to enhance or protect their commercial or financial position. We urge the OECD to remove Paragraph 93 as it requires tax authorities to identify and judge alternative business transactions without an objective basis for determining whether those alternative are really available and realistic, and whether or not they would enhance or protect taxpayers’ commercial and financial positions. Tax authorities may not be reasonably qualified (nor are they expected to be) to make complicated business or commercial judgments, particularly given the need for projecting financial results of a transaction when assessing whether a transaction enhances or protects taxpayers’ commercial and financial positions.
CONCERNS WITH CERTAIN EXAMPLES IN CHAPTER 1 REVISIONS

We acknowledge the need to provide examples to illustrate specific points of guidance. Examples are useful in providing taxpayers and tax authorities a more concrete and relatable application of the guidance provided, illustrating the type of facts and circumstances where the OECD believe its guidance applies.

We are, however, concerned that a number of the examples provided in the revisions to Chapter I could reasonably be resolved using the existing guidance provided by the OECD in other chapters of the transfer pricing guidelines (or will be taken care of by other BEPS Action Plan initiatives.)

We are troubled by the possibility that the additional guidance provided under Chapter I will conflict, or could be interpreted as conflicting, with guidance provided in Chapter II (Transfer Pricing Methods), Chapter III (Comparability Analysis), Chapter VI (Special Considerations for Intangible Property), Chapter VII (Special Considerations for Intra-Group Services), Chapter VIII (Cost Contribution Arrangements), and Chapter IX (Transfer Pricing Aspects of Business Restructurings). Because Chapter I outlines the general principles and concepts the remainder of the transfer pricing guidelines are supposed to implement, perceptions of inconsistencies or conflicts between Chapter I and other chapters are likely to be resolved by the tax authorities by deferring to Chapter I—and their own interpretation of the Chapter I guidance, as trumping any and all subsequent guidance provided in the other chapters. Thus, we believe it is of the utmost importance that the OECD provides guidance in Chapter I that is carefully examined against guidance provided in all other chapters.

We have provided an extensive discussion of two examples where the OECD’s analysis missed the transfer of fixed costs from one party to the other. These examples were at Paragraph 57 (page 20) and Paragraph 90 and 91 (Pages 26 and 27). Guidance provided under Chapter VI of the transfer pricing guidelines (September 2014) is sufficient to resolve both examples without the need to amend the contract between the parties. Tax authorities, however, may feel that Chapter I trumps Chapter VI and may, as a result, feel empowered by Chapter I to rewrite the contract. The resulting lack of predictability as to which chapter and guidance governs the analysis is unfortunate for both taxpayers and tax authorities, and likely to generate controversy that is hard to mediate and resolve objectively.

Because of the importance of this issue we illustrate our point further by commenting on a number of other specific examples found in Chapter I. Each example we comment on below is incorporated herein by reference to the paragraph where it can be found in Chapter I; italicized text signals a direct quote from the text of the example.
Example at Paragraph 6 (Page 5)

Although S may not seem to be operating as a licensee, as discussed in the section on Identifying Commercial and Financial Relations, and as illustrated in Figure 5, there are two ways to handle this particular scenario. The first is to attempt to price the contract between the parties (a license) by (i) identifying third-party comparable licenses, for example; and (ii) identifying all material differences between the third-party licenses and the actual substance of the license transaction between P and S, and adjust for those differences. Because P provides a number of support activities (which we note is in the best interest of P to provide to S, since P’s revenue depends on the commercial success of S), we would expect adjustments to the royalty paid by S to P to reflect the value of those support activities. The second way to handle this particular scenario is to rewrite the contract as a service contract whereby S provides services to P. This is the approach favored by the OECD. Since rewriting this contract can have non-tax collateral consequences (e.g., legal, accounting, covenants with banks), and for all the reasons we discussed in the Identifying Commercial and Financial Relations section, we strongly believe that every effort should be made to use the valuation guidance found in Chapter VI to price this contract, instead of rewriting it.

Example at Paragraph 8 (Page 6)

This example is ambiguous because it lacks an explanation of (i) what is the nature of the relationship between P and its subsidiaries (e.g., a license to distribute, a license to use intellectual property in a manufacturing process); and (ii) what comparable transactions or companies were used to price that relationship. Suppose P is a licensor of intellectual property and the comparable transactions used to price the license include the provision of services by the licensor to support the exploitation of the license by the licensee. Since the provision of support services is already priced in the relationship between P and its subsidiaries, no separate service agreement is necessary and no separate transaction should be recognized.

Example at Paragraph 44 (Page 17)

In this example the contract says that the distributor assumes all exchange risks in relation to this controlled transaction. The example concludes that because the manufacturer sells to the distributor in the distributor’s currency (the euro), the contractual terms do not reflect the actual commercial or financial relations between the parties. We disagree. The example is not sufficiently developed factually to provide a basis to conclude whether or not the behavior of the parties is consistent with the contractual terms. First, the example discusses only accounting foreign exchange risk (that is, the risk resulting from holding some assets or liabilities in a currency other than the functional currency that can result in accounting gains or losses on currency). Accounting foreign exchange risk is only one type of foreign exchange risk, and it is one
that is not particularly relevant to a transfer pricing analysis. We indicated in the section on “What Risks Are Relevant for Transfer Pricing” that only risks that are priced by the market are relevant for transfer pricing. Accounting foreign exchange risk can be hedged at a very low cost and diversified away. It therefore has minimal value (the value is the marginal cost of the hedge).

A much more significant source of foreign exchange risk is called economic foreign exchange risk. Economic foreign exchange risk is the risk of a company’s revenue or costs (i.e., gross margin) all denominated in functional currency, to swing as a result of currency movements. For example, a French manufacturer and distributor of cars, purchasing all raw materials in France in euro and selling all finished cars in Europe in euro could experience gross margin fluctuations as a result of movements of the Japanese yen against the euro. A favorable currency movement could allow, for example, Japanese car manufacturers to decrease their euro-denominated car price in Europe and force European manufacturers and distributors to adjust their euro-denominated prices to maintain their market share. This risk is significantly more market-correlated (and hence priced by the open market) than the accounting foreign exchange risk discussed in the example. This also illustrates that market-correlated risk cannot be controlled by any market participant—currency exchange rates are outside their control.

Example at Paragraphs 46 and 47 (Page 17)

The discussion in this example (and in the previous example as well) focuses on risks that have an accounting impact on companies rather than focusing on a discussion of the economic risks faced by MNEs. Similarly, the impression from these two examples is that the risk management functions that are relevant are about mitigating the accounting exposure of the associated enterprises. Risks relevant for a transfer pricing analysis are risks priced by the market—the market does not price accounting risks unless they are market-correlated. Real economic risks are different from risks of booking gains and losses in accounting records; there may be some overlap and correlation between the two, but the focus should be on real economic risks that are market-correlated since these are the risks that are priced in the open market, and hence result in a correct application of the arm’s length principle.

Example at Paragraph 60 (Page 20)

Product recall involves the assumption of a contingent obligation to fund fixed costs. When the distributor contractually agrees to be financially responsible for product recalls (the contingency), its future expected cash flows are decreased by the probability of product recalls multiplied by the expected financial cost commitment of a product recall. A correct transfer pricing analysis should then examine whether the resulting expected cost liability, when and if it materializes, will vary with the level of revenue of the distributor or not. This is a factual question of great importance, but the facts in the
example are insufficient to answer that question. If the factual development of the case leads to the conclusion that product recall costs are largely fixed costs (that is, not perfectly correlated with the then current revenue), then the contractual assumption of these expected costs increases the distributor’s cost of capital at the time of the contractual arrangement.

The valuation of the compensation required to make the distributor indifferent between not assuming product recall costs (and operating at a lower cost of capital) and assuming product recall costs (and operating at a higher cost of capital) will be a function of (i) the probability of product recall: the example assumes that the business has not had any product recalls; and the manufacturer engages in stringent supplier audit programs, extensive testing protocols, mandatory training and a culture of improvement—which suggest in this particular fact pattern that the probability of product recall is low, which will result in a low value for the contractual provision; and (ii) the expected financial commitment required, should a product recall occur. The example’s conclusion that the risk should be allocated to the manufacturer is again unnecessary with a careful arm’s length valuation of that element of the transaction. This contract can thus easily be priced and should therefore be respected and priced under the application of the arm’s length principle.

We also disagree with the assertion that the distributor has no capability to assess the risk or effectively monitor risk mitigation. The distributor has access to the same information the functional analysis of an outsider revealed: no history of product recall, stringent supplier audit programs, extensive testing protocols, mandatory training, and a culture of improvement. At arm’s length, as long as there are personnel at the distributor capable of understanding the recall risks, the distributor has control over which manufacturer it wants to do business with, and the distributor should be able to assess and manage its risk. The forces of the open market will compel manufacturers operating in industries where product recalls carry significant reputational risk (for instance, the food industry, baby car seats, and strollers) to compete on quality assurance and monitoring (which means that the quality assurance activity does not carry a premium). Should the manufacturer’s quality assurance procedures and monitoring slip, the distributor can terminate its relationship with that manufacturer and go to the open market to develop a relationship with another manufacturer. We therefore disagree with the analysis and conclusion reached by the OECD in this example.

Example at Paragraph 63 (Page 21)

We believe that this example contradicts the real world. For example, in the gas and oil industry there are companies that own specialized equipment that is leased to unrelated companies that provide drilling services to third-party customers. The company engaged in the marketing function could be either or both; the value thereof is
easily assessed and attributed to the party performing the function for transfer pricing purposes.

We also disagree with the statement that the return allocated to the risk management function might be high since utilization is a core risk affecting the asset-owner’s income stream. As explained before, competitive labor markets ensure that risk management cannot be a high-return function (see Risk Management and Control Over Risks section). In addition, the leasing company has control over risks, because it can decide to terminate its relationship with the company that operates the equipment, should that company not manage risks properly. Again, there is a competitive open market that forces these operating companies to offer competent and qualified risk management functions or be priced out of the market. The conclusion that the lessor deserves only a financial return, while the party allegedly performing the risk management function should be allocated the upside and the downside of the business is thus contrary to what is observed in the real world, and contrary to the application of the arm’s length principle: the risk management function and the marketing functions should receive routine returns, and the lessor is likely to receive a high return because the fixed costs associated with ownership of expensive equipment.

A potential whipsaw situation could occur because of a change in the contractual allocation of risk. In good times, tax authorities are likely to argue that the lessee is entitled to additional compensation for its risk management and marketing services, perhaps even a split of the profits. But as we know from recent events, the oil and gas business is a cyclical business. If the specialized equipment is no longer being used because of an industry down turn, will tax authorities permit the taxpayer to “disregard” its own contract to allocate the loss to the lessee? We are concerned that arguing substance could become one-sided in favor of the tax authorities.

RESPONSES TO “SPECIAL MEASURES”

The question whether there is a need for “special measures,” either within or beyond the arm’s length principle, to prevent BEPS was raised at the commencement of the BEPS project. At that time, there was concern that the application of the arm’s length principle permitted base erosion and profit shifting in some circumstances, particularly linked to intangibles and centralized business models. Those questions were raised before work on interrelated Action Plan items—including Action 3 (strengthen CFC rules), Action 4 (interest deductions), Action 8 (intangibles transfer pricing) and Actions 9 and 10 (transfer pricing risk and capital) had progressed. Given those proposed changes, it is likely that the application of arm’s length transfer pricing principles, together with the other proposed changes, means that special measures are not likely to be required.

Adoption of special measures would amount in those limited circumstances to the abandonment of the arm’s length principle and the adoption of an alternate form of profit apportionment. We suggest that an alternative form of profit allocation should
not be adopted until the existing proposals are adopted and implemented and have proven unsuccessful. We note that the OECD will review the implementation of the new documentation rules in 2020. We suggest that the OECD take a similar position with respect to special measures.

The discussion draft suggests that special measures may be needed to eliminate any residual BEPS risk because of information asymmetries between taxpayers and tax authorities, and the relative ease with which MNEs can allocate capital to low-taxed, low-functioning entities. Special measures are proposed in the draft for:

- Hard-to-value intangibles sold for a lump sum where projections and contemporaneous robust projections and analysis are not made available to tax authorities. We understand the difficulty in determining whether a taxpayer’s ex-ante projections and analysis are sufficiently robust. However, we are also concerned that any special measures end up simply being an ex-post recalculation of the transfer prices, contrary to the arm’s length principle of ex-ante pricing under full uncertainty. By their nature, projections are simply estimates of the future that experience suggests are likely to be incorrect. Correctly risk-weighted projections could recognize that certain outcomes have a low probability. However, low-probability events occur all the time. In addition, macroeconomic events (market-correlated risks) and other forces outside taxpayers’ control do occur and can change outcomes. At arm’s length these factors would not permit unrelated parties to renegotiate a transaction. See, for example, the United Kingdom case of *Force India Formula One Team Limited v Aerolab SRL* [2012] EWHC 616 (Ch). However, as between unrelated parties, it is still possible to test the reasonableness of the data upon which each party seeks to rely at that time (see the French Supreme court decision in the case of *Arcelor Mittal – Sollac v Mr Audibert* [2013]). Any special measure will need to take into consideration the fact that the most robust ex-ante projections are unlikely to accurately predict ex-post outcomes. Unrelated parties accept this risk; tax Authorities should also accept this risk.

Nonetheless, we do recognize that some projections may not be sufficiently robust, or that circumstances may not permit companies to accurately project the future. However, we believe the circumstances when tax authorities can disregard taxpayers’ projections must be carefully prescribed. In addition, the OECD should consider a safe harbor in which a taxpayer’s projections will not be challenged in the absence of clear evidence that the taxpayer failed to exercise due diligence, to permit the tax authorities to focus on those situations that warrant additional analysis.

- Inappropriate returns for providing capital by reference to a hypothetical “independent investor” test or “thick” capitalization by reference to capital global ratios. We believe special measures are unlikely to be necessary in light of work on Action 4, dealing with interest deductions, and Action 8, dealing with intangibles.
• Minimal functional entities that lack the functional capacity to create value and rely on a framework of arrangements with other group companies leading to a mandatory profit split or CFC-style apportionment. We believe special measures are unlikely to be necessary once the transfer pricing guidelines are amended as a result of Actions 8, 9, and 10.

• Ensuring appropriate taxation of excess (low-tax) returns, including a primary controlled foreign corporation (CFC) rule and a secondary rule to allocate taxing rights to other jurisdictions. Again, we believe special measures are unlikely to be necessary in light of amendments to transfer pricing rules as a result of Actions 8, 9, and 10 and the tightening of CFC rules under Action 3.
TECHNICAL APPENDIX

GENERAL FRAMEWORK

Consider two members of a multinational enterprise (MNE), Affiliate A—a manufacturer, and Affiliate B—a distributor. Without loss of generality, assume that (i) Affiliate A purchases (in the open market) all raw materials from third parties; (ii) Affiliate B sells (in the open market) all finished products to third parties; and (iii) neither Affiliate A nor Affiliate B engage in any other controlled transactions. It follows that the consolidated profit of the MNE is dictated by the forces of the open market, and is thus by definition arm’s length.

The transfer pricing problem consists in determining the price at which Affiliate A should sell its products to Affiliate B, given the fact that these transactions are removed from the forces of the open market because they occur between associated enterprises.

Figure 1 and Figure 2 summarize the steps required in the application of the arm’s length principle to the pricing problem between Affiliate A and Affiliate B.

**Step One: The Written Contract**

Under common law a contract exists between parties when they know and agree the same thing and intend to be bound by that understanding. A contract can be written, verbal, or implied. The written contract is a document that sets out the express terms of the agreement between the parties, and it is signed by both to indicate that it is correct. Between unrelated parties, the written contract is a legally binding document that governs the rights and obligations of both parties and thus allocates the consolidated risks to each party. Written contracts should be as clear, unambiguous, and complete as possible. In that context, a complete contract is defined as a contract that specifies, for each possible contingency that may occur under the contract (resolution of uncertainty) what the outcome will be for each party to the contract. The written contract is therefore the starting point of the transfer pricing analysis, and of the application of the arm’s length principle.

Complete contracts are inherently difficult to draft. Therefore, even between unrelated parties the actual contract between the parties may not be fully described only by the express terms of the contract. A contract may contain terms that are not expressly stated but are implied, either because the parties intended this, by operation of law, by custom or usage, or by the conduct of the parties. In the event the contract does not address an issue, or the parties have intentionally modified the contract, the actual conduct of the parties may provide evidence to complement the written contract. In such cases, courts in many countries have concluded that the true contract between the parties is one that reflects their actual interaction. The written contract must be the starting point for transfer pricing analysis of the true contract between the related parties, because in the absence of a showing that the parties intended to modify the
contract it represents the structure of the transaction they intended to enter into. Only in those cases when the contract is unclear or the parties purposely intended to modify the contract should the terms of the contract be implied from the actions of the parties.

**Step Two: Risk Analysis**

Ex-ante risk is not directly observable. Although the ex-post realization of risk may be observable (e.g., the development activity failed or was successful), the pricing of transactions between associated enterprises takes place before (ex-ante) risks are realized. The inability to directly observe ex-ante risks forces the transfer pricing analysis to (i) infer the risks allocated to the parties from the written contract, and to the extent not contained in the written contract, from the actions of the parties (see Step One above); and (ii) to infer risks from what can be observed, namely, assets used, functions performed, and cost structures. This analysis of risks requires great care, as the correlation that may exist between assets, functions, cost structures, and risks is not perfect and can be altered contractually. This underscores again the importance of the written contract.

The risk analysis results in an assessment of the portion of the consolidated risks borne by Affiliate A and Affiliate B, respectively.

**Figure 1: Transfer Pricing Problem**

**Figure 2: Application of the Arm’s Length Principle**

IS THIS A STRAY GRAPHIC OR PART OF FIGURE 2?

**Step Three: Application of the Arm’s Length Principle**

In Figure 1, each party to the transaction is allocated an expected return outside the forces of the open market. These expected returns are graphically represented by the points denoted “Affiliate A” and “Affiliate B” in the risk-expected return space of Figure
1. Because an MNE can allocate the consolidated expected return of the transaction between associated enterprises, in Figure 1, only the point denoted “Consolidated (Market)” cannot be changed by the MNE; the points “Affiliate A” and “Affiliate B” can be moved by the MNE, as long as the sum of the expected returns allocated to Affiliate A and B is equal to the consolidated expected return.

How are MNEs to determine an acceptable allocation of expected return between associated enterprises? Figure 2 illustrates the application of the standard that has been affirmed and reaffirmed by the OECD as the answer to that question, namely, the arm’s length principle.

The arm’s length principle states that the pricing of a transaction that took place outside the forces of the open market between associated enterprises will be respected if consistent with the pricing that would have emerged from the forces of the open market applied to that transaction. This idea is captured in Figure 2 by the open market efficient risk-expected return frontier.

Figure 2 was designed to illustrate an arm’s length price; indeed, the MNE provided expected returns to Affiliate A and B on the open market’s efficient risk-expected return frontier. Notice that the point “Consolidated (Market)” is always on the efficient-risk return frontier since the MNE (in our example) as a whole is subject to the forces of the open market.

**Step Four: Benchmarking the Efficient Risk-Expected Return Frontier**

The OECD transfer pricing guidelines provide substantial guidance to evaluate whether a particular transfer pricing solution is, or is not, on the efficient risk-expected return frontier. This guidance is predicated on the idea that by observing open market outcomes of comparable transactions (transactional benchmarking), or comparable use of assets, comparable performance of functions, and comparable cost structures (profit-based benchmarking), controlling in both instances for the level of risk (i.e., under comparable circumstances), we can estimate the expected return provided by the open market. Figure 3 below illustrates how the benchmarking exercise is typically conducted.

**Figure 3: Testing the Arm’s Length Nature of Transfer Prices**

Figure 3 illustrates the use of five comparable companies to establish an interquartile range of returns. It is not particularly important for purposes of this illustration which
specific measure of return is selected; however, in a real world application of these methodologies, it is of great importance—market-based measures of ex-ante or ex-post returns may be very different from accounting measures. Figure 3 assumes five comparable companies with comparable levels of risk as the tested party—the assessment of comparability comes from examining the written contract, examining the assets used, the functions performed, and the cost structures of the tested party and of the candidate comparable companies. Notice that none of the measured returns (ex-post) are on the actual efficient risk-expected return frontier of Figure 3; this is because of the use of accounting measures of ex-post returns and measurement errors, as opposed to the use of real market-based measures of ex-ante returns. In the particular test of Figure 3, the tested party would be deemed to have satisfied the arm’s length principle.

It is understood that the use of ex-post returns to estimate ex-ante expected returns, as is done in transactional benchmarking and in profit-based benchmarking, is not ideal; however, for routine transactions that do not involve the development or exploitation of risky intangible assets, averaging ex-post returns should provide a reasonable estimate of ex-ante expected returns.

For transactions that do involve the development and exploitation of risky intangible assets, the OECD issued in September 2014 revisions to Chapter VI, providing additional guidance aimed at better measuring ex-ante expected returns on the efficient risk-expected return frontier by using discounted cash flow (DCF) methodologies.

The existence of an efficient risk-expected return frontier that provides for each level of risk one single price (i.e., expected return) is fundamental to the entire field of Economics. It is referred to as the Law of One Price and it results from the competitive forces of the open market. Without the Law of One Price, none of the guidance provided by the OECD in connection with benchmarking would make sense—multiple prices could and would be found for the same transaction, at the same level of risk, with the same use of assets, performance of functions, and cost structures, depending on which benchmarks are used; there would therefore not be an objective principle that could be applied to determine transfer prices. More importantly, it would imply the survival of arbitrage opportunities in the open market—a violation of the very principle of open market competition.

Figure 4 summarizes how the forces of the open market aggregate (i) the risk preferences of investors; and (ii) the realistic alternatives available to investors into a single and unique price. In Figure 4, three investments of equal risk but different expected returns are offered in the market place. Because all three investments carry the same level of risk, rational investors will select the investment with the highest expected return; that investment is denoted as C. Demand for investment C will increase and its price will increase accordingly—decreasing its expected return. Similarly, demand for investment A will decrease and its price will decrease accordingly—increasing its expected return. Demand and supply for each investment will clear when the three investments carrying the same level of risk provide the same
expected return—that expected return is the expected return of investment B in Figure 3. At that point, all arbitrage opportunities between investments A, B, and C have disappeared. Any investment offered outside the efficient risk-expected return frontier will similarly disappear and the Law of One Price will emerge from the competitive forces of the open market.

**Figure 4: The Open Market Efficient Risk-Expected Return Frontier**

The efficient risk-expected return frontier is generally not linear. Its curvature reflects the risk-aversion of investors—as risk increase, proportionally greater increase in expected return have to be provided to induce investors to accept that greater level of risk. The key properties of the efficient risk-expected return frontier are listed below; they are extremely relevant to our subsequent comments on the proposed revisions to the Guidance.

**Properties of the Efficient Risk-Expected Return Frontier:**

1. The curvature of the frontier reflects the aggregation of risk-preferences of market participants;
2. The frontier aggregates all realistically available investment opportunities offered to market participants into one unique price for any level of risk; and
3. Investors are indifferent between any and all pairs of investments on the frontier—these investments have the same value (defined as risk-adjusted expected return).

**Figure 5: Contractual Adjustment to Price or Risk in Contracts**
Consider Figure 5, where the transaction between Affiliate A (a manufacturer) and Affiliate B (a distributor) was governed by a contract that allocated risks (perhaps due to missing elements in the contracts) between the parties inconsistently with the pricing of the contract (based on an application of the arm’s length principle). This is captured in Figure 5 by having the risk-expected return of both parties outside the efficient risk-expected return frontier. Assume that the distributor (Affiliate B) was the tested party. At the level of risks assumed by Affiliate B the open market would have provided Affiliate B with a greater expected return (and vice versa for Affiliate A).

Figure 5 illustrates the two ways that tax authorities could resolve the conundrum of inconsistencies between the contractual allocation of risk and the pricing of that risk. One option is to respect the contractual allocation of risk and initiate a transfer pricing adjustment that will decrease the expected return of Affiliate A and increase the expected return of Affiliate B, in such a way that both end up back on the efficient risk-expected return frontier.

The second option is to respect the pricing and rewrite as little of the contract as possible so that each affiliate is allocated risks consistently with said pricing and both end up back on the efficient risk-expected return frontier.
Andrew Hickman,
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development

2 rue André-Pascal
75775, Paris
Cedex 16
France

Submitted by email: TransferPricing@oecd.org

Subject: BEPS ACTIONS 8, 9 AND 10: DISCUSSION DRAFT ON REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERISATION, AND SPECIAL MEASURES)

Dear Mr. Hickman

Diamond Offshore Drilling, Inc. “(Diamond”) appreciates the opportunity to comment on the OECD’s Discussion Draft entitled BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures), (“Discussion Draft” or “Draft”). We also appreciate and acknowledge the complex task faced by the OECD as it identifies and addresses the diverse and interdependent issues contained in the G20’s BEPS project.

We also want to acknowledge the OECD BEPS working party for its efforts on the Discussion Draft and the efforts it has made to clarify how to analyse and accurately delineate the nature of related transactions, particularly as they relate to the relevance and allocation of risk and value creation. We understand that the Discussion Draft and the other OECD BEPS Action Plans represent a complex and interrelated effort. As a global business that strives to comply with the world’s transfer pricing and international tax laws, Diamond feels it is important to have fair and consistent laws that minimize the potential of double taxation and lowers the administrative and compliance burden associated with meeting our tax obligation. Therefore, we feel it is important to express our thoughts about the Discussion Draft.
Background

Diamond is a U.S. company headquartered in Houston, Texas, USA. We provide contract drilling services to the world’s oil and gas (“O&G”) exploration and development companies (“O&G Company”) throughout the world. We are a capital-intensive business that invests in large, expensive mobile offshore drilling units (rigs) designed to drill on the continental shelf under potentially severe and dangerous conditions. With proper maintenance, continual capital investment and equipment upgrades, an offshore drilling rig can last over 20 years. However, investing in offshore drilling rigs is a risky business subject to the evolving exploration plans and budget constraint of a few O&G Companies, competition from onshore O&G projects such as the recent increase in fracking of shale properties, and the challenge of frequently changing offshore production regulations and technologies.

O&G Companies hire Diamond to drill one or more wells on a location determined by and at the direction of the O&G Company personnel. Our services and the offshore drilling rig is a derived demand based from the O&G Company’s need to produce additional O&G, its inventory of potential hydrocarbon properties, and its expectation of the cost to develop the reserves. The type (or specifications) of the offshore drilling rig is dictated by the O&G Company based on various factors such as water depth, weather, sea conditions, geology of the property and the scope of the drilling program. The rig specification is the primary consideration of the O&G Company in making its decision to enter into a contract drilling services agreement. If Diamond does not have a drilling rig that meets the requested specifications, it will not qualify to bid for the contract regardless of its relationship with the customer or the quality of its employees.

If Diamond is fortunate enough to win the work, it follows the drilling program. Once all the wells in the drilling program are drilled, irrespective of whether the wells are dry holes or contain economic hydrocarbons, the drilling services contract is completed. The O&G Company releases the drilling rig and it is available for another customer anywhere in the world requiring the rig’s unique specification. In a given year, the rig may work in two or more countries under the same or different drilling services agreements.

---

1 It should be noted that Diamond does not have an economic interest in the hydrocarbon.
General Comments

Diamond supports the OECD’s effort to provide governments and industry with a consistent set of guidelines to minimize double taxation and provide guidance on how to appropriately apply the arm’s length standard to related party transactions. It is our belief that the arm’s length standard, even with its weakness, provides a reasonable and market-driven method for pricing related party transactions thereby minimizing the potential for double taxation. Appropriately applied, the arm’s length standard will result in the pricing of intercompany transactions that reflects how independent businesses transact and minimize the potential of double taxation.

Diamond’s global transfer pricing policies strive to reflect the economics of each transaction and in doing so makes every effort to ensure the company’s transfer pricing outcomes appropriately reflect the value the market and our customers place on the equipment and service we provide while meeting its international tax and transfer pricing obligations.

Specific Comments

The Discussion Draft addresses numerous topics that impact business decisions and how a company will meet its international tax and transfer pricing obligations. Diamond has limited its comments to areas we feel the Discussion Draft does not fully address or where the analysis may not appropriately describe the business reality Diamond faces as a capital-intensive business. We understand various business organizations and companies are providing comments and we respectfully ask the OECD BEPS Working Party to consider all comments which discuss how the Discussion Draft may limit a market-based transfer pricing guidance. With this proviso, we limit our comments to the following:

1. Need for additional clarity on value creation, particularly on how an asset creates value

The Discussion Draft’s central theme is aligning the arm’s length pricing of the transaction with value creation when applying the arm’s length standard to related party transactions. Section D.1 states that, in analysing the transaction, a functional analysis should seek to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed and managed by the parties to the transactions. Paragraph 10 identifies five broad categories of economically relevant characteristics which should be considered, including the functions performed, assets employed and risks assumed, and managed and the economic circumstances of the market surrounding the transaction. Paragraph 16 further recognizes that a
functional analysis should seek “to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed and managed by the parties to the transactions” as well as the importance of understanding “how value is generated by the group as a whole, the interdependencies of the functions performed by the parties with the rest of the group, and the contribution that the parties make to that value creation.”

After recognizing that many economically relevant activities contribute to value creation, the Discussion Draft then focuses primarily on value creation attributed to the performance of an activity or the performance of managing risk and not the economically relevant activity itself (the transaction) or those factors valued by the market when third parties enter into a transaction. This is particularly exhibited in Paragraph 63 which presents an example of how a specialist equipment owner’s return is limited to a financing return because the asset owner does not perform the activities or manage the risks associated with the commercial opportunities potentially generated through the asset. While the paragraph acknowledges a specialty equipment owner incurs investment risks and insurable loss or damage risks, the example states the relevant risk the asset owner faces in exploiting commercial opportunities is the risk associated with the asset’s utilization. The example concludes that the mere ownership of a specialist asset “is in substance providing financing equal to the cost of the asset, and should be remunerated on that basis.” Without the ability to perform all the other activities associated with the commercial opportunity, the asset would not be utilized and earn a return.

Diamond disagrees with the conclusion in paragraph 63 and feels the analysis does not consider the following:

**Return associated with a unique asset (return to capital)**

The example attributes all the returns from the market place to performing activities or controlling the risks associated with the activity. The example implies it is the people functions around the related party transaction that is driving value creation. Value created by the mere ownership of the specialized asset is not acknowledged. We believe the conclusion ignores the significant role the asset plays in creating value.²

In the drilling industry, this is not the case. Our customers pay for the unique characteristics of an offshore drilling rig. If an O&G Company’s drilling program calls for a drilling rig with certain specifications, it asks drilling companies to bid for the contract. If a drilling company has a rig in its

² Our intent is to provide practical industry related examples. For a more rigorous explanation we refer the reader to the vast academic literature on the subject.
inventory that meets the specification and is available to work when the O&G Company needs it, the drilling company will price the rig according to market conditions. As with market, as the number of available rigs falls relative to demand, the price (or dayrate) increases. Likewise, during periods of low demand and rig surpluses, the dayrate drops. However, there is no significant difference in the type and level of activity performed by the marketing, technical and risk management personnel during times when a shortage or surplus exists. Only the rig crew changes as more crew is hired as rigs begin working. In the case of the drilling industry the inherent characteristic of the asset demanded by the O&G Company creates value.

The drilling industry unprecedented growth in demand and dayrate during the fourth quarter of 2004 provides an example of how value was created by an asset. From 2002 through the first three quarters of 2004, rig utilization rate for the industry’s floating rigs averaged about 80%. The average dayrate price for the lower-end drilling rigs (capable of drilling in waters less than 3,000 feet) was about $55K/day while the higher end rigs (>7,500 feet) averaged about $150K/day. Then in the last quarter of 2004, the O&G companies demand for offshore drilling increased. Over the next two years the average utilization rate increased to 91% and dayrates increased significantly. By the fourth quarter of 2006, the dayrate for lower-end rigs averaged about $324K/day and dayrate for higher-end rigs averaged about $440/day.\(^3\) Figure 1 presents the average drilling dayrate from 2001 through 2014.

\[\text{Figure 1: Average Drilling Rig Dayrate (Semisubmersible Drilling Rig <3000\textdegree)}\]

\(^3\) IHS-Petrodata data.
Value was created by the drilling industry’s customers and their demand for a specialized asset. The change in dayrate that started in late 2004 did not significantly alter the level of marketing activity, back office support of the specialized equipment or the management of risk required by the rig owning entities. These activities are required by all businesses to maintain their viability, irrespective of the market condition.

The asset owner is entitled to an entrepreneur risk

The example in paragraph 63 ignores the entrepreneurial role of the asset owner. An entrepreneur makes investment in an asset because it believes its future earnings from owning the asset is greater than it can make elsewhere in the market. The entrepreneur is betting the return is greater than a straight financial return or a safe, low-risk investment (e.g., treasury bonds). In exchange for taking the higher risks, it also accepts the potential that the investment will generate a loss. During market downturns the asset owner must carry the asset, with all the risks associated with the equipment. The entrepreneur can eliminate virtually all other activities expect carrying the asset.

Most of the activities performed by the entrepreneur are performed prior to the investment. However, the return for assuming the risk occurs throughout the life of the investment either by using the investment to produce a product or service or by selling the asset.

Companies like Diamond invest in rigs based on their anticipated returns from future contract drilling service agreements. The returns from fluctuation in price should be earned by the asset owner. Paragraph 63 does not recognize the entrepreneurial risk incurred by the asset owner.

Commercial opportunity exists because of the asset

The performance of activities is a necessary condition but not a sufficient condition for value creation. In an asset-intensive industry, value creation results from the interaction of all activities related to the transaction. Performing activities like marketing, operating equipment and managing risks contribute to the value creation; however, the mere presence of routine activities does not guarantee that value is created. These activities occur during high and low value creation periods. As described above, in late 2004 the demand for offshore drilling rigs increased dramatically creating value for the industry as oil companies demanded drilling rigs. The industry performed virtually the same level of marketing, operational and risk management activity prior to and after the market changed.

Diamond believes these activities are necessary business functions. However, they were not sufficient by themselves to create value alone. To better understand how value is created, the
Discussion Draft should incorporate the role assets play in value creation and the return associate with that role.

*Not rewarding the asset with an appropriate return distorts the economic results of the transaction*

By focusing on the performance of the activities, the Discussion Draft only focuses on one area that contributes to value creation and distorts the results that would be achieved by third parties entering into the same transaction. Value creation is a function of all the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions (“Transaction Factors”). Some of the Transaction Factors are routine in nature performed by all companies and command only little return, as discussed by the OECD BEPS Action 10 on Low Value-Adding Services. Other Transaction Factors are non-routine, contributing more to value creation. By not recognizing the contributions of all the Transaction Factors, the example introduces a distortion not seen among third parties and does not result in an arm’s length result.

Diamond believes that appropriately applied, the arm’s length standard and transfer pricing principles contained in the OECD’s Transfer Pricing Guidelines results in a reasonable market-based estimate of the price for the performance of services and thereby their contribution to value in a related party transaction. The market-based estimate minimizes the potential distortion transfer pricing has on a transaction and double taxation.

**Business and commercial reasons exist for owning assets in separate legal entities**

Business and commercial reasons exist for a company to own tangible assets in separate legal entities. The offshore drilling industry provides an excellent example. The offshore drilling industry owns expensive assets, worth millions of dollars. We provide contract drilling services using the same asset to third parties around the world. The mobility of our assets means the drilling rig may work in more than one country in a given year or on locations over which two or more countries claim taxing jurisdiction. Over time the industry where our assets are held has changed in response to our customer’s needs and operational demands.

2. Additional guidance is needed on the application of the non-recognition principle

Section D.4 of the Discussion Draft introduces and discusses the circumstances when a transaction can be disregarded for transfer pricing purposes. It states non-recognition of a related party transaction is needed when the transaction does not have the fundamental economic attributes of arrangements between unrelated parties. The fundamental economic attributes of the
arrangement must be viewed in its entirety and provide each party with the ability to enhance its commercial or financial risk-adjusted position given its other opportunities realistically available.

Introducing the concept of non-recognition of a related party transaction provides a tax authority with a tool that allows it to disregard a transaction or use the possibility of disregarding the transaction to leverage a result to its advantage, possibly leading to double taxation.

By introducing non-recognition, the Discussion Draft appears to be moving away from performing a detailed transfer pricing analysis under the arm’s length principle. Once disregarded, the tax authority can recharacterise the transaction the way it wants. While the Discussion Draft attempts to warn the tax authority to limit its use of non-recognition of a transfer pricing transaction and provide some guidance on what fundamental economic attributes of an arrangement between unrelated entities might constitute a reason for not recognizing the transaction, Diamond believes the temptation may be too difficult to resist when the tax authority is under pressure to collect additional tax revenue.

Diamond may be particularly wary because of the recent events of the UK. After Diamond and most of the rest of the industry entered into Advanced Pricing Agreements to set an arm’s length price for bareboat chartering rigs, both the UK tax authority and Treasury recommended tax legislation that disallowed the deduction of a portion of any related party bareboat charter, even if the price was arm’s length. The rule does not apply to third party bareboat charters, thereby significantly increasing the cost of doing business for any drilling company chartering a rig from a related entity.

By introducing non-recognition into the Transfer Pricing Guidance, taxing authorities will be tempted to find reasons to disregard the transaction. If the transaction is recharacterised, double taxation is likely.

3. Special Measures need further development or to be eliminated

The introduction of special measures by the Discussion Draft appears to be duplicative and unnecessary. The Discussion Draft states the special measures “within or beyond the arm’s length principle” may be required to ensure that the transfer pricing outcomes of certain transaction are in line with value creation and are targeted to certain transaction related to intangible assets, risk and over-capitalisation. Diamond believes in the arm’s length standard and the transfer pricing principles contained in the OECD Guidelines are sufficient to adequately ensure the transfer pricing outcome of a related party transaction is in line with value creation. Appropriately applied, any
abuses can be addressed through a thorough functional analysis and the application of the arms-length standard.

Introducing special measures will also introduce additional uncertainty and will lead to inconsistent results for Diamond as each tax authority develops its perspective of how the special measure applies to the drilling industry. The special measures should be significantly increased or eliminated.

Conclusion

Diamond appreciates the opportunity to comment on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures). We support the efforts by the OECD BEPS Project team to provide clarity to the challenges a business faces as it complies with international tax and transfer pricing laws. We hope you find our comments useful.

We look forward to participating in the public consultation. If you should have any question please do not hesitate to contact me.

Submitted on behalf of Diamond by,

Clifford A Mangano, Ph. D.
Director - Global Transfer Pricing
Diamond Offshore Drilling, Inc.
Comments on the Public Discussion Draft
BEPS Actions 8, 9 and 10:
Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)

February 4, 2015

Mr. Andrew Hickman
Head of Transfer Pricing Unit
OECD, Centre for Tax Policy and Administration
By email: TransferPricing@oecd.org

Sir,

We are pleased to provide detailed comments on the public discussion draft BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures) (the draft) through the consultation taking place from December 1, 2014 to February 6, 2015.

This document may be posted on the OECD website. Full credit goes to Robert Robillard, DRTP Consulting Inc.¹

1. Overall design of part D

   1.1. It may be relevant to start Part D with paragraph 10.

   1.2. Part D.1 (Identifying the commercial or financial relations) is in fact about contractual terms. Should it not be labelled as D.1.1? There seems to be some confusion in the hierarchy of the titles and sub-titles.

¹ Robert Robillard, CPA, CGA, MBA, M.Sc. Economics, is Senior Partner at DRTP Consulting Inc. and Tax Professor at Université du Québec à Montréal; 514-742-8086; robertrobillard@drtp.ca. He is also the Transfer Pricing Chief Economist at RBRT Transfer Pricing (RBRT Inc.) and a former Competent Authority Economist and Audit Case Manager at the Canada Revenue Agency.
1.3. For transfer pricing purposes, the analysis should start with the characterization of the product or service and then be followed by the functional analysis.

1.4. The whole draft gives the eerily feeling that contractual terms, in particular the risk profiles of the parties, should be front and center of the transfer pricing comparability analysis.

1.5. Methodologically speaking, this is incorrect from a commercial standpoint (the taxpayer) and from a compliance tax audit perspective (the tax administration).

1.6. Most transfer pricing cases start with a “transaction” which implies that functions have been performed by at least one of the parties, whether it is through the provision of a product or the rendering of a service (see paragraphs 46 and 48 of the draft for that matter).

1.7. The comparability analysis (new part D) should therefore be re-aligned on Part D of Chapter I of the OECD Guidelines (July 2010).

1.8. In general, the examples included in the text make it more cumbersome and unnecessarily 482-flavored.²

2. Unchanged paragraphs 102-103

2.1. It is a shame to see that not a single iota of guidance is proposed in this draft to finally align the transfer pricing and custom valuation public policies.

2.2. This international tax confusedness should have been taken care of a long time ago for the benefit of taxpayers and tax administrations alike all around the world.

² Section 1.482 of the Code of Federal Regulations of the United States (transfer pricing) dwells a little too much at length in this “narrative-example cycle”. This does not always result in added clarity for taxpayers.
3. New paragraph 2

3.1. On the one hand, new paragraph 2 introduces the notion of “the rest of the value chain” in the examination of the contractual terms of a specific controlled transaction.

3.2. Although it may seem relevant from a theoretical perspective, such an examination would necessitate access to qualitative information that will not be made available neither through the Master file nor the CbC reporting template.

3.3. That information will likely reside in the Local file which is not meant to be accessible to every tax administration according to Part E of the Guidance on Transfer Pricing Documentation and Country-by-Country Reporting released on September 16, 2014.

3.4. On the other hand, we fail to see the relevance of “the rest of the value chain” for the determination of an arm’s length price.

3.5. Parties dealing at arm’s length would not directly consider the dealings of their other clients or suppliers to establish the terms and conditions of their own dealings.

3.6. Parties dealing at arm’s length would not directly take into account their own dealings with other clients or other suppliers unless the typical principal-agent problem was disrupted (i.e., information asymmetry).

3.7. The introduction of the notion of “the rest of the value chain” is another OECD drift toward global formulary apportionment.  

---

4. New paragraphs 3-6

4.1. These two paragraphs provide additional guidance on the relationship between contractual terms and the actual conduct of the parties.

4.2. These changes and additions are welcome. They will greatly benefit tax administrations in which the audit process has lacked this fine understanding of the proper examination of the contractual terms and their impact on the arm’s length transfer pricing determination.

4.3. The specific examples could have nonetheless been omitted from the text. They make the text more cumbersome.

5. New paragraphs 7-8

5.1. Although they may seem to “flow” from the previous paragraphs, new paragraphs 7-8 read like the creation of controlled transactions “out of thin air” by tax administrations.

5.2. These paragraphs should be removed from the draft.

5.3. They corrupt the “commercial rationality test” of the OECD Guidelines as highlighted and reiterated in paragraphs 88-92 of the draft.

5.4. These paragraphs will create more disputes and litigations between taxpayers and tax administrations and among tax administrations.

6. New paragraphs 10-14

6.1. We suggest removing the notion of “economically relevant characteristics” from these paragraphs in relation to comparability factors.

6.2. The notion of “comparability factors” is more than enough for clarity purposes as they are thoroughly defined in the guidelines.

6.3. With the inclusion of “economically relevant characteristics” in the first sentence of paragraph 11, the last sentence is somewhat circular…
7. New paragraphs 17-18

7.1. The examples provided in these paragraphs may in fact be “low value-adding intra-group services” based on the curious rational suggested in BEPS Action 10: Proposed Modifications To Chapter VII of The Transfer Pricing Guidelines Relating To Low Value-Adding Intra-Group Services. 4

7.2. Assuming that the text must be burdened with all those examples, they may not be the best examples available.

8. New paragraph 21

8.1. See our above comments on new paragraph 2.

8.2. This is a clear drift toward global formulary apportionment.

9. New paragraph 38

9.1. This is incorrect. Risks are in fact easily identified.

9.2. It is the quantum related to risks that poses challenges in transfer pricing.

9.3. Quantum means the potential amount of monetary losses which may derive from the realization of various types of risks (see paragraphs 48-49 of the draft on that matter).

9.4. Quantum also means the amount of monetary gains that may ensue from the risk-taking activities (see paragraphs 48-49 of the draft on that matter).

10. A comment on the “risk-return trade-off curse”

10.1. We are of the opinion that this notion has strictly no relevance to the determination of an arm’s length price.

---

4 OECD Public Discussion Draft, BEPS Action 10: Proposed Modifications To Chapter VII of The Transfer Pricing Guidelines Relating To Low Value-Adding Intra-Group Services, 3 November 2014 – 14 January 2015, see paragraphs 7.46 and 7.48. We have already provided comments on this draft.
10.2. It is a bottom-line driven notion that has considerably contaminated the transfer pricing comparability analysis in the last 20 years.

10.3. There is a significant amount of risks and uncertainty in any economic endeavour. 5

10.4. In spite of unfounded assertions to the contrary, the commercial dealings of corporate entities with specific risk profile can be totally reasonable from a legal, regulatory, accounting, economic or commercial perspective.

10.5. The variety of conceivable commercial dealings is made possible since corporate entities are creatures of the legal and commercial minds.

10.6. Paragraphs 41-42 of the draft provide to that effect a better framework to analyze risks in transfer pricing.

10.7. However, the analysis of functions should precede the analysis of risks (see paragraph 43 of the draft and the above comments on the overall design of Part D).

11. New paragraphs 57-59

11.1. New paragraph 57 suggests that “it should not be concluded that the pricing arrangements adopted in the contractual arrangements (see Section D.2.2) determine the respective contributions to risk management.”

11.2. This is simply incorrect in any arm’s length setting.

11.3. Pricing arrangement will indeed reflect the respective contributions to risk management, that is, indirectly.

11.4. This assertion degrades the “commercial rationality test” of the OECD Guidelines as highlighted and reiterated in paragraphs 88-92 of the draft.

11.5. Paragraphs 57-59 should be removed from the draft.

11.6. Otherwise, they will create more disputes and litigations between taxpayers and tax administrations and among tax administrations.

12. New paragraph 60

12.1. New paragraph 60 is incorrect when it states that “the parties’ assumption of risk does not in itself determine that they should be allocated the risk for transfer pricing purposes.”

12.2. This is called arbitrary “re-characterization” of the risk profile.

12.3. Paragraph 60 is also contaminated with the “risk-return trade-off curse” discussed above.

12.4. This paragraph should be removed from the draft.

12.5. It goes against the “commercial rationality test” of the OECD Guidelines as highlighted and reiterated in paragraphs 88-92 of the draft.

12.6. The following paragraphs linger on this unsubstantiated notion in an arm’s length environment.

12.7. These paragraphs will create an explosion of re-characterization cases which will end up in more tax disputes and tax litigations between taxpayers and tax administrations and among tax administrations.

13. New paragraphs 67-69

13.1. New paragraphs 67-69 seem to be misplaced. Perhaps they require a subtitle.

13.2. It should be pointed out that the discussion mixes the notion of alleged “low value-adding intra-group services” with other types of services (with respect to the risk level that they entail).

13.3. More clarity is hence required.
14. New paragraphs 70-71

14.1. New paragraph 70 suggests that risks may be transferred otherwise than at arm’s length. This is trivial.

14.2. The discussion is once more explicitly contaminated with the “risk-return trade-off curse”.

15. New paragraphs 73-78

15.1. It must be underlined that these paragraphs will not create the much-needed balance to prevent the likely abuses by tax administrations identified above.

16. Final comments on “special measures”

16.1. Options #1, #2, and #3 basically suggest indirect partial formulary apportionment mechanisms.6

16.2. Option #4 pertaining to “minimal functional entity” directly relates to global formulary apportionment. Option #4 is also about re-characterization.

16.3. Option #5 is (another) direct attack on the sovereignty of specific countries where the taxation mix is not mostly based on income tax.

16.4. In short, these options have every ingredient conducive to more tax disputes and litigations between taxpayers and tax administration and among tax administrations.

Robert Robillard, CPA, CGA, MBA, M.Sc. Economics  
Senior Partner, DRTP Consulting Inc.  
Professor, Université du Québec à Montréal  
514-742-8086  
robertrobillard@drtp.ca

February 4, 2015

6 We do not adhere to the thesis that these “options” are applications of the safe harbour principles in Part E of Chapter IV of the OECD TP Guidelines (as it was amended on May 16, 2013). There are simply too many indirect references to formulary apportionment in the OECD public discussion drafts lately.
Mr. Andrew Hickman
Head of Transfer Pricing Unit
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

Delivered via e-mail: TransferPricing@oecd.org

Re: Commentary on BEPS Actions 8, 9, and 10 – Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization, and Special Measures)

Mark Bronson, Michelle Johnson, and Kate Sullivan; Duff & Phelps, LLC

Dear Mr. Hickman:

We appreciate the opportunity to offer commentary on the OECD’s discussion draft on risk, recharacterization, and special measures. We understand and appreciate the OECD’s concerns that practices associated with risk transfers may lead to opportunities to engage in BEPS, and that as a practical matter, the OECD is particularly concerned that entities with minimal functions have been a vehicle for achieving these ends.

As a general matter, we do not view the transfer of risks between legal entities to necessarily enable base erosion and inappropriate profit shifting. Transactions involving the transfer of risk are commonplace between third parties and are not fundamentally at odds with the arm’s length standard. Furthermore, when properly priced, risk transfers in isolation should not give rise to BEPS on an ex ante basis. In our view, the potential for BEPS does not arise directly from the ability to transfer risks, but rather from the mischaracterization and/or mispricing of that risk. These practices can lead to transaction structures and terms that inappropriately convey value without proper compensation.

We believe that the guidance already in place, most notably the arm’s length standard and the realistic alternatives principal, can (and should) still be relied upon as the foundation for the treatment of risk transfers. Adopting the revisions contained in this discussion draft is likely to lead to additional uncertainty for taxpayers and could potentially increase the

---

1 The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of Duff & Phelps as a whole or those of its clients.
likelihood of double taxation, even on transactions between affiliated entities that do not pose a BEPS risk.

Our comments specifically address the following issues:

- **Moral Hazard:** Imposing the moral hazard framework on related party transactions is inappropriate given that the very issue it is trying to address (i.e., incentive misalignment) generally does not exist in an intercompany context. We are concerned that the imposition of this unnecessary framework, in conjunction with some of the guidance motivated by it, could lead to increased incidents of double taxation, and in certain circumstances, even have the effect of discouraging cross border investment by multinationals.

- **Managing and Controlling Risk:** The moral hazard framework seems to drive the determination that “the mere contractual allocation of risk is not likely to be seen at arm’s length without the ability to control that risk.”\(^2\) The draft guidance suggests that, as it relates to core risks, such risks will be allocated to the party that *manages and controls* the risks. Even if one assumes that the moral hazard framework should apply, along with its attendant considerations of risk allocation at arm’s length, the breadth of activities defined as risk management under the draft guidance may result in circumstances in which a profit split is not necessary to analyze a transaction, but is nonetheless applied by a tax authority when it is to their benefit to do so. If the moral hazard framework is to govern, the guidance should clarify that *control* of risk is the determinative factor with respect to the allocation of risk (consistent with, and as defined in, Paragraphs 9.23 to 9.28 of the business restructuring guidance), and that contractual allocations of risk should be respected so long as the party that is allocated the risk exercises control over that risk. The mere undertaking of activities that would fall under the draft guidelines’ current definition of risk management and performance of risk mitigation functions should not be sufficient to result in an automatic allocation of risk (and the associated *ex post* returns associated with those risks) to the party(ies) undertaking those activities. We believe that the proposed language on risk management and mitigation and the implied consequences of that language could, if left as is, violate the arm’s length principle, result in a substantial increase in double tax cases (and strains on Competent Authority resources), and ultimately, discourage cross-border investment by multinational corporations.

- **The Role of Capital:** The language in this discussion draft suggests that capital in the absence of performance risk management or control should only generate a risk-free return. This conclusion is at odds with the arm’s length standard.

---

\(^2\) Paragraph 61 of the Public Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures). Henceforth, this report will be referred to simply as the discussion draft.
Non-Recognition: The discussion of circumstances in which non-recognition may apply is, in our opinion, far too broad and could result in tax authorities inappropriately recharacterizing transactions that satisfy the arm’s length standard. This result derives from provisions allowing non-recognition when controlled transactions do not exhibit the “fundamental economic attributes” of an arm’s length transaction – an inappropriate and overly broad construct which appears to be driven, in part, by the troublesome moral hazard framework.

Moral Hazard

This draft appears to represent a significant change in the thinking of the OECD member countries relative to the 2010 Guidelines – seemingly placing far more emphasis not only on the function of controlling risk (which was, in part, already addressed in Chapter IX in 2010), but also of managing risk. The introduction of this broader threshold (i.e., that risks can only be allocated to parties with the capacity to manage and control those risks) is apparently motivated, in part, by moral hazard considerations.

In unrelated party transactions, the logic expressed in the draft report is reasonable – i.e., that moral hazard dictates that risk bearing and risk management functions should generally be aligned, particularly where incentive misalignment problems are potentially material and where such problems cannot be resolved efficiently through contracts. Unrelated parties, for example, might be hesitant to engage in transfers of critical IP due to concerns about the ability to protect that IP (i.e., an unrelated licensee might have an incentive to act in a way that is contrary to the interests of the entity that owns the IP). While third-parties could theoretically try to solve the problem of incentive misalignment contractually, the costs of doing so would likely be very high. 3

A core component of the value proposition of operating a business in a corporate form is the elimination of costs that might arise from these types of problems in an open market. That is, within a firm, actions can be undertaken and efficiencies achieved that would be very difficult to undertake or achieve strictly through market mechanisms. Consequently, these incentive alignment concerns generally do not exist in the context of controlled transactions. The discussion draft acknowledges this. It states that “the existence of common control will generally mean that there is no need to contractually align incentives in order to ensure that one party will not act contrary to the interests of the other.” 4 The discussion draft also recognizes that “[a]ssociated enterprises may have the ability to enter into a much greater variety of arrangements than can independent parties” and that “the mere fact that the

---

3 For instance, an IP owner that licensed a core technology to a third party would need to closely monitor the use of the IP which could be prohibitively costly.

4 Discussion of moral hazard on Page 14 of the discussion draft.
transaction may not be seen between independent parties does not mean that it should not be recognized.\footnote{Paragraph 84 of the discussion draft.}

It is our understanding that the OECD believes that, as long as an intercompany transaction has substance, it should be respected even if that same transaction would not be likely to occur between third parties (e.g., the transfer of core IP, per the example above). This is, in part, because the lack of incentive alignment issues means that economically rational transactions can occur in related party contexts that might not be observable “in nature.” This is completely appropriate – failing to recognize such transactions would be illogical, because as described, related party transactions exist in part to exploit one of the core value propositions of the corporate form (i.e., the absence of high transaction costs associated with incentive misalignment).

Following this logic, it seems counterintuitive to apply a third-party behavioral standard to risk allocation when the OECD has acknowledged that it would not be appropriate to apply a similar standard more broadly in an intercompany context. Much like in our core IP licensing example, incentive alignment issues do not exist (or are substantially mitigated) within the firm as it relates to risk.

If moral hazard did not exist in a third-party context (i.e., if incentives among third parties were perfectly aligned as it related to risk mitigation and management), one would expect to see broad variation in the contractual allocation of risk between the parties, including arrangements that do not reflect any correlation between the allocation of risk and risk management activities. When incentives are aligned, bearing risk becomes a strictly financial matter. That is, risks will be borne by the party (or parties) that has (have) more tolerance for risks, and contractual terms would need to be set such that the risk bearing party was appropriately rewarded (in expectation) for bearing that risk. Thus, the introduction of the moral hazard framework and the risk allocation consequences of that imposed framework would force risk allocations in an intercompany context that would not be imposed at arm’s length under similar circumstances (i.e., if moral hazard did not exist in a third-party context).

Consequently, we believe that the imposition of the moral hazard framework is inappropriate and at odds with the arm’s length principle. This framework is so pervasive throughout the draft that removing the assumption of moral hazard would substantially eliminate much of the guidance in the discussion draft. Nevertheless, we think it is important to comment on other aspects of the guidance. As such, the comments in the remainder of this commentary take the moral hazard framework as given, and discuss concerns that we have even if one is assumed to be operating within that framework.
Managing and Controlling Risk

The draft guidance places a significant amount of emphasis on the management and control of risk as a requirement for earning returns associated with such risk. If the moral hazard framework is to govern, the guidance should be clearer that control of risk is the determinative factor with respect to the allocation of risk (as defined in Paragraphs 9.23 to 9.28 of the business restructuring guidance), and contractual allocations of risk should be respected so long as the party that is allocated the risk exercises control over that risk or has the capacity to do so.

The Chapter IX guidance from 2010 focuses on two characteristics that may help to determine whether a contractual allocation of risk should be respected. Specifically, paragraph 9.20 states that:

The determination [of whether the contractual allocation of risk is consistent with the arm’s length principle] is by nature subjective, and it is desirable to provide some guidance on how to make such a determination….One relevant, although not determinative factor that can assist in this determination is the examination of which party(ies) has (have) relatively more control over the risk….Another factor that may influence an independent party’s willingness to take on a risk is its financial capacity to assume that risk.

The Chapter IX guidance notes that while other factors may also be important in certain circumstances, control and capacity are the only factors that can be included in a prescriptive list for every situation.

Within Chapter IX, control is really focused on the capacity to make decisions to take on the risk and decisions on how to manage the risk, internally or using a provider. 6 Paragraph 55 of the discussion draft states that risk management comprises three elements:

(i) the capability to make decisions to take on or decline a risk-bearing opportunity and the performance of that decision-making function;
(ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity and the performance of that decisions-making function; and
(iii) the capability to mitigate risk. That is, the capability to take measures that affect risk outcomes, together with the actual performance of that risk mitigation function.

Control relates to elements (i) and (ii). We will refer to (iii) as “performance” of the risk mitigating functions.

6 Paragraph 9.23.
The discussion of risk in Paragraph 42 contains a number of different types of categories of risks. One category ("infrastructure or operational risks") includes uncertainties associated with the company’s business execution and may include the effectiveness of processes and operations. Examples included in this discussion of this type of risk include risks of breakdowns, risks that production will be insufficient to meet demand, and risks that products will not be produced to appropriate quality standards. The breadth of this discussion is such that it is hard to imagine what managerial functions, if any, an enterprise might perform that would not be characterized as a risk mitigation function under this definition.

This becomes important because the discussion draft states, in Paragraph 60, that “the parties’ assumption of risk does not in itself determine that they should be allocated the risk for transfer pricing purposes. It is relevant to enquire how the risks are controlled in the business, as well as which parties’ functions enable it to face and mitigate the risks associated with business activities.” Taken altogether:

(i) Contractual risk allocations are seemingly only of secondary importance for the purposes of determining which party will be allocated risk for transfer pricing purposes;
(ii) In addition to control of risks, performance of risk mitigation functions is a key determinant of which party will be allocated risk for transfer pricing purposes (Paragraph 60); and
(iii) Risks are so broadly defined that the guidance could be interpreted to mean that any entity performing managerial functions is performing a risk mitigation function of some form (Paragraph 42).

These points might lead one to think that virtually all transactions will need to be analyzed under a profit split framework given the fact that, under the definition in the discussion draft, multinational enterprises would almost always be deemed to be performing risk management and mitigation functions in multiple locations across the globe. With that said, there are places in the draft that attempt to limit this interpretation; however, this only creates more ambiguity regarding the factors that will ultimately drive the determination of risk allocation among related parties.

---

7 For example, Paragraph 76 notes that in some instances, controlled and uncontrolled parties may face a set of common risks and perform similar risk management activities in which case application of a TNMM may result in appropriate compensation. This exception is subject to its own limiting language that the equivalence of risk management activities needs to be thoroughly established through the functional and comparability analysis. In light of the fundamental differences between how related parties interact and how unrelated parties do (for instance, with respect to greater trust in the decision processes of subsidiaries relative to third party distributors), and given the limited information that is available regarding potential comparable companies for a TNMM application, one might reasonably expect that tax administrations could almost always find a reason that a TNMM does not reflect appropriate compensation given the allocation of risk under these guidelines. Further, Paragraph 78 states that “In determining if any party or parties should have profits adjusted to take into account the difference between the expected outcome and the actual outcome, consideration should be paid to the nature of the risks and which party or parties control these risks.” Paragraph 62 states that “at arm’s length the risk is more likely to be assumed by the party which manages the risks or which if risk mitigation measures are outsourced, controls the risk.”
To eliminate some of this uncertainty, it is our opinion that **control should be determinative with respect to the allocation of risk for transfer pricing purposes** (consistent with the guidance in Chapter IX). Risk mitigation activities (especially as it relates to risks as they are so broadly defined) are commonly outsourced to third parties. For instance, an automotive manufacturer might hire a third-party consulting firm to assess its quality control procedures to mitigate its risks related to production failures. The consultant would be paid for its services based on agreed terms, but those terms would not be contingent upon the results of those efforts (i.e., the consultant would not be held liable in the event of a production failure). This is one illustrative example of the separation of risk bearing and risk mitigation, but a myriad of examples exist. In our opinion, the performance of risk mitigating functions should, in isolation (and absent control), play no role in the allocation of risk for transfer pricing purposes and would be inconsistent with the arm’s length standard.

In addition, given the use of decentralized decision-making frameworks within many multinational enterprises, it is important to note that control should not mean the day-to-day management of risks and day-to-day decision-making, but rather exercising control within the meaning of Paragraphs 9.23 to 9.28 of the business restructuring guidance. Furthermore, the discussion of risks in Paragraph 42 of the discussion should be modified such that an entity is not presumed to be controlling important risks just by virtue of the fact that it controls the execution of ordinary operations and processes. The "breakdown" discussion in Paragraph 42, for instance, might lead one to believe that the existence of a plant manager who ensures that all machinery is functioning optimally is sufficient to determine that the entity employing that manager is controlling risks, and thus, the entity should presumptively be compensated with something other than a routine return (e.g., by applying the profit split method to analyze the transaction).

Under the existing language, one could even envision scenarios in which multinational enterprises might outsource certain functions to third parties rather than perform them internally due to uncertainties around the treatment of the potential intercompany transaction. For instance, if setting up a routine manufacturing entity would require allocating anything more than a reasonable routine return to that entity for the function because certain risk management functions are performed there, then it might be prudent to choose to outsource that manufacturing activity to a third party. This is the case, in part, because third party transactions cannot be recharacterized, and therefore the tax consequences of entering into a third party transaction are known. These draft guidelines leave the consequences of the intercompany transaction highly uncertain. Transactions might, inclusive of tax effects, be less expensive if undertaken with third parties due to the nature of this draft guidance.8

---

8 The likelihood of this could be mitigated if the draft guidance were to include language (similar to the language in the section on non-recognition) that acknowledges the legitimacy of risk allocations observed in uncontrolled transactions. That is, tax authorities should not be able to reallocate risks if the contractual allocation of risk between related parties is consistent with observed risk allocations in third-party transactions. To be clear, we do not think that third party risk allocations should be determinative for recognition of risk allocations between
Returns to Capital

The discussion draft does not appear to assign any meaningful role to capital as a determinant of which parties bear risk, and hence as a driver, in part, of expected returns. In the discussion draft, capital alone would not be allocated any risk for transfer pricing purposes in the absence of risk management. Therefore, one might conclude, capital should attract nothing more than a risk-free rate. This appears to be contrary to .draft paragraphs 6.60 and 6.61 of the revised Chapter VI guidance released last year. Paragraph 6.61, for instance, states that "[b]earing a funding risk, without the assumption of any further risk generally would entitle the funder to a risk-adjusted rate of anticipated return on its funding, but not more."

If it is the intention of this discussion draft to impose this sort of “risk-free return” framework, that intention would be inappropriate and inconsistent with the arm’s length standard. Parties regularly provide capital to unrelated entities for investment purposes on a passive basis, bear risks of loss on that capital, and expect returns that are appropriate for those very real risks that they bear. In highly uncertain environments (for instance, investments in early stage technology through venture capital investments), expected returns to compensate for this risk can be substantial.

If this guidance is driven by some belief that capital contributions by minimally functional entities are not real or should not be respected, then the guidance should address the respect for capital allocations more directly rather than trying to force such non-recognition into the arm’s length standard.

Non-Recognition

The current draft guidance states that “it is recommended that every effort is made to determine the actual nature of the transaction and apply arm’s length pricing to the accurately delineated transaction, and that non-recognition is not used simply because determining an arm’s length price is difficult.” Unfortunately, it is our opinion that the draft guidance on non-recognition is likely to lead to more, not fewer, instances of non-recognition.

The draft guidance states that “the key question is whether the actual transaction possesses the fundamental economic attributes of arrangements between unrelated parties.” Paragraph 85 of the discussion draft states that “attributes of non-arm’s length arrangements can be facilitated by the ability of MNE groups to create multiple separate group companies, and to determine which companies own which assets, carry out which activities, assume

related parties. Paragraph 76 may be intended to accomplish this purpose, but its ability to do so may be limited. See footnote 7.
9 See also discussion draft paragraph 78: “[a] party which does not control risk will not be allocated the risk and therefore will not be entitled to unanticipated profits.”
10 Paragraph 84 of the discussion draft.
11 id.
which risks under contracts, and engage in transactions with one another accordingly, in the
knowledge that the consequences [of these allocations] is overridden by control."

This statement seems to imply that the absence of “consequences” related to the allocation of
risks, assets, and functions due to common control make related party transactions lack “the
fundamental economic attributes of arrangements between unrelated parties.” This
characterization of the potential abuses deriving strictly from common control is reiterated in
Paragraphs 87 and 88 of the discussion draft. Consequently, this framework seems to
suggest that transactions that segment functions across entities should potentially be subject
to non-recognition because companies might not make such allocations if common control
wouldn’t mitigate the potential ill effects of incentive misalignment.

This characterization of what would or would not be respected as an arm’s length transaction
seems, again, dependent on a moral hazard framework that is inapplicable in most
intercompany transactions. As described, in the absence of moral hazard, attribution of risk
among the parties should primarily be a financial question (i.e., which party has the most
tolerance for bearing the risk, and how that risk should be rewarded). Appropriately pricing
the risks that are borne by the parties (assuming such risk allocations are recognized and
have substance) can be difficult in some circumstances given the absence of direct “real
world” value chain divisions with similar allocations of functions, assets, and risks.
Nevertheless, under the language in the draft guidance, this difficulty should not, in isolation,
mean that the transaction is not recognized; however, the concern is that it will lead to just
that.

In Paragraph 89, the discussion draft states that “an arrangement exhibiting the fundamental
economic attributes of arrangements between unrelated parties would offer each of the
parties a reasonable expectation to enhance or protect their commercial or financial positions
on a risk-adjusted.…basis, compared to the other alternatives.” Under Paragraph 9.60 of the
business restructuring guidance,

“[a]lternative structures realistically available are considered in evaluating whether the
terms of the controlled transaction (particularly pricing) would be acceptable to an
uncontrolled taxpayer faced with the same alternatives and operating under
comparable circumstances. If a more profitable structure could have been adopted,
but the economic substance of the taxpayer’s structure does not differ from its form
and the structure is not commercially irrational such that it would practically impede a
tax administration from determining an appropriate transfer price, the transaction is not
disregarded.”

While it may not have been the intent of the draft guidance, the absence of language
indicating that enhancement of commercial or financial positions is strictly a question of value
seems telling. Under the existing language (and, in particular, in light of the example of
paragraphs 90 and 91 of the discussion draft), it would seem that tax administrations are
given free rein to evaluate intercompany transactions across a broad range of attributes that
could be termed “commercial positions,” particularly given the use of the wording “commercial or financial positions.” Under this language, tax administrations could choose to not recognize transactions because they have alternative theories about what might have been better from some broader commercial perspective. Tax authorities should be concerned with ensuring that appropriate value is received when assets are transferred. They should not be concerned with second guessing the broader business judgments of taxpayers.

Our concern regarding the inappropriate application of the non-recognition guidance is substantially heightened by the example and discussion in paragraphs 90 and 91 of the discussion draft. In that example, a company (S1) that owns and uses a trademark sells it to another related company for $400 million. The affiliated buyer (S2) is in a low tax jurisdiction, and has several employees with capability to assess, monitor, and direct the use of the trademark by the selling entity (therefore, by our interpretation, S2 may have the capability to control risks). However, S2 does not have the resources to directly exploit that purchased trademark. That is, S2 will be licensing the trademark back to S1.

We are told that the royalty will be set so that the royalty “equates to a financing return.” We read this statement to mean that the net present value of the royalty stream will be equal to the $400 million paid for trademark. This transaction is highlighted as an example of a transaction that should be disregarded because “it is difficult to see how, if the parties were independent, S1 is afforded the opportunity to enhance or protect its commercial or financial position… S1 is likely to have lost commercial value in that it no longer owns the trademark that is key in generating its income, and is subject to additional risk in that it is reliant on another party (S2)… to license the trademark and not to take actions which might enhance value for itself but potentially detract from Company S1…”

It appears as though non-recognition is based strictly on an assessment that commercial or financial positions are not enhanced. The example doesn’t seem to indicate that anything is incorrect with the pricing itself (i.e., we assume that the pricing is consistent with the arm’s length standard if the transaction were recognized). Under these assumptions:

- Neither party is worse off and the realistic alternatives principle set forth in paragraph 9.60 would seem to be satisfied. That is, it is hard to understand why the tax administration in S1’s country is worse off unless the transfers were inappropriately priced; and
- The sole reason for non-recognition is that the transaction has been deemed to not be in the commercial interest of S1 by the tax administration in S1’s country (seemingly based on a moral hazard framework that is irrelevant in an intercompany context).

---

12 Paragraph 90.
13 Paragraph 91.
Unrelated parties do, in fact, choose to engage in transactions where variable return streams are exchanged for fixed return streams (e.g., swap transactions). Therefore, the example in Paragraph 90 looks much like financial transactions that do occur between unrelated parties, at least from a strictly financial perspective. Such transactions occur because of differences in risk tolerances. On a net present value, risk adjusted basis, both parties may be in substantially similar positions before and after the transaction, but the swap better serves the risk preferences of the parties to the transaction. Risk tolerances are an entirely valid consideration in determining whether “commercial” positions have been enhanced, but seem to have been largely ignored in the draft guidance.

Taken as a whole, Section D4 of the draft creates a standard allowing for a much greater occurrence of non-recognition based on a moral hazard framework that is not relevant in an intercompany context. The realistic alternatives principal embedded in the already existing guidance should create a sufficient threshold for evaluating actual transactions relative to available alternatives – a threshold that is strictly value-based and not subject to highly subjective second guessing about business judgment and strategy.

******************************

Thank you for the opportunity to provide commentary on the discussion draft as the OECD continues its important work to combat BEPS abuse.

We are happy to discuss the issues we have raised in this paper in more detail. Please contact Mark Bronson at Mark.Bronson@DuffandPhelps.com, Michelle Johnson at Michelle.Johnson@DuffandPhelps.com, or Kate Sullivan at Kate.Sullivan@DuffandPhelps.com for more information.
European Business Initiative on Taxation (EBIT)

Comments on the OECD's Discussion Draft on

BEPS ACTIONS 8, 9 AND 10: DISCUSSION DRAFT ON REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERISATION, AND SPECIAL MEASURES)

1 December 2014 - 6 February 2015

At the time of writing this submission, EBIT Members included: AIRBUS, BP, CATERPILLAR, DEUTSCHE LUFTHANSA, DIAGEO, GSK, INFORMA, JTI, LDC, MTU, NUTRECO, REED ELSEVIER, ROBECO, ROLLS-ROYCE, SAMSUNG ELECTRONICS, SCA, SCHRODERS and TUPPERWARE.
Dear Andrew,

EBIT is grateful for this opportunity to provide comments on the OECD Public Discussion Draft on BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures), hereinafter: “the Discussion Draft”).

**General comments**

EBIT’s Members support the Discussion Draft’s efforts to provide additional guidance on the re-draft of Chapter I of the OECD Transfer Pricing Guidelines with a view to preventing BEPS.

We welcome the Discussion Draft’s revised Section D of Chapter I of the Transfer Pricing Guidelines in Part I which quite accurately identifies the limited situations where it makes sense to look past the contractual terms and documentation in order to determine the appropriate treatment for transfer pricing purposes.

EBIT also supports the Discussion Draft’s recognition that the delineation of transfer pricing transactions should reflect business realities, and should take into account actual conduct of parties and actual allocation of risk, and that contractual terms mirror these business realities best in principle.

We welcome the recognition by the OECD in the Discussion Draft that the identification and allocation of risks is an essential and inherent component of day-to-day commercial activities. EBIT Members consider that risk can be (and is) often centralised and managed most effectively away from where the operational activities are.

EBIT Members consider with regard to Part II that any special measures should ideally be consistent with the arm’s length principle. The number of cases beyond the arm’s length principle where special measures are required, should in our view be kept to a minimum, and be applied as a last resort and back up to the guidance in Section D of the Discussion Draft. Such special measures should be invoked following a good faith negotiation between taxpayers and the tax administrations regarding the application of Section D. EBIT believes that it is essential to provide clear and unambiguous guidance and assistance to tax administrations which will allow them to apply the Transfer Pricing Guidelines correctly.
Specific comments

D. GUIDANCE FOR APPLYING THE ARM’S LENGTH PRINCIPLE

D.1 Identifying the commercial or financial relations

EBIT Members would welcome further clarification of the broad scope of the Discussion Draft’s concept of commercial or financial relationships between associated enterprises in the context of the Transfer Pricing Guidelines.

The Discussion Draft states in paragraph 3 that written contracts provide the starting point for delineating the transaction between independent enterprises and how the responsibilities, risks, and benefits arising from their interaction are to be divided. EBIT wishes to reiterate that written commercial contracts are more often than not at the heart of any commercial and financial arm’s length relations between independent enterprises.

The Discussion Draft states that where no written terms exist or the conduct of the parties shows that the contractual terms are ambiguous, incorrect or incomplete, the delineation of the transaction “should be deduced, clarified, or supplemented by the tax administration based on the review of the commercial or financial relations as reflected by the actual conduct of the parties”. EBIT is concerned that the subjective term “deduced” may be interpreted by tax administrations as giving them wider discretion in deciding for companies what is commercially reasonable and in disregarding contracts and transactions more easily. EBIT wishes to emphasise the importance of providing clear and unambiguous guidance to tax administrations as regards the correct application of the Transfer Pricing Guidelines.

The Discussion Draft in paragraph 7 refers to an example whereby a transfer of value through technical assistance may have been granted and introduces the concept of synergies that may have been created through “deliberate concerted action” or know-how which may have been provided through seconded employees or otherwise. EBIT urges the Discussion Draft to clarify what is meant exactly with the newly introduced concept of “deliberate concerted action” as it is not elaborated further, if and how this ties in or complements the widely accepted concept in transfer pricing of group synergies as an advantage of being part of a group, how it can be used in practice by tax administrations, and how consistency with the arm’s length principle can be assured. Further guidance on this is important because the role of synergies in value creation is extremely complex and certainly not undisputed in the transfer pricing arena.

More generally, we are concerned that the concept of “synergies” and some of the other concepts used in this section of the Discussion Draft, such as “interdependencies”, “coordination,” and “integration”, seem to be used inappropriately because they seem to assume that an MNC is a single enterprise. We also note that this theoretical framework in this section would make it easier to justify non-recognition of transactions and disregarding contractual allocations of risk, but it may not be fully in line with today’s business realities.

D.1.1 Functional analysis

The concept of “capability” is added to the functional analysis as a factor in identifying the economic circumstances of the commercial and financial relations. EBIT Members are concerned that this addition introduces unnecessary complexity to the functional analysis and significantly increases the administrative burden for multinational groups. It may also lead to possibly different pricing for the same transaction based upon the “capabilities” of the parties.
D.1.4 Business strategies

Further guidance regarding the analysis of business strategies and their impact on a controlled transaction would be helpful because otherwise the proposed analysis seems to merely introduce adding subjectivity to the risk analysis.

D.2. Identifying risks in commercial or financial relations

We welcome the statement that risk is inherent in commercial activities and that the identification and allocation of risks is an essential component of a comparability analysis.

EBIT’s Members consider that risk can be (and is) often centralised and managed most effectively away from where the operational activities are.

We generally concur with the statement in paragraph 66 of the Discussion Draft that: “financial capacity to bear risk is a relevant but not determinative factor in considering whether a controlled party should be allocated a risk return.”

As an example: an offshore cash-box provides finance to an operating affiliate, but notwithstanding the contractual terms) the cashbox entity plays no material role in the management or control of risk, or in monitoring/reviewing the activities of those to whom it has outsourced the management or control of risk, and neither does it appear to have the capability to do so. In this case, we would agree with the proposition that the starting point in calculating the return to the cashbox company is that it should be a financing-type return – albeit a relatively high financing return reflecting the inherently risky nature of the activities being financed and the resultant uncertainty in the repayment of the financing.

Additional points – Imputed moral hazard

EBIT believes that whilst moral hazard exists in some but certainly not all third party transactions, it is very difficult under the arm’s length principle to appreciate when moral hazard should be imputed in a multinational group.

D.2.5 Risk management

The Discussion Draft concludes too easily in our view that a company’s decision to outsource risk mitigation or management, which is common commercial practice, does not involve risk and that such decisions will automatically result in that company losing control of the risk process or delegating all of the risk.

The Discussion Draft cites line management in business segments, operational entities and functional departments as a good solution. In practice, line management does not indicate per se whether the top level reporting entity really controls the risk or not, and we think it would be helpful if the Discussion Draft could clarify how line management and outsourcing risk management interlink and interact.

D.4. Non-recognition

Whilst EBIT Members welcome the statement that every effort should be made to determine the actual nature of the transaction and apply arm’s length pricing to the accurately delineated transaction, and that non-recognition is not used simply because determining an arm’s length price is difficult, the proposed Guidelines should ensure that taxpayers are not inappropriately confronted with non-recognition. In our view, non-recognition should therefore be explicitly mentioned in paragraph 82 as a last resort.

EBIT Members believe that the Discussion Draft’s recommendation that an entity, which has a separate legal personality, can be disregarded, should be considered with great caution and
applied only in cases where it can be clearly demonstrated that the involvement of a particular legal entity is a sham. To do otherwise, would undermine the fundamental legal concept of separate legal personality and unjustifiably breach the TFEU/EEA freedoms regarding EU/EEA national companies/other local entities. We would also point out that CJEU case law in our view severely limits the ability of EU/EEA tax authorities to lawfully recharacterise transactions, as to do so other than in the case of sham or wholly artificial arrangements fails to meet the legal certainty test laid down by the CJEU in the SIAT Belgian cross-border deductions case (C-318/10) as reiterated by the CJEU in the Itelcar Portuguese Thin cap case (C-282/12).

Part II – POTENTIAL SPECIAL MEASURES

EBIT Members consider that any special measures should as far as possible be consistent with the arm’s length principle, and that there exists no consensus among the BEPS-44.

We are concerned that the Discussion Draft at this already late stage of the BEPS process does not provide specific or substantial guidance as to how these special measures would function and should be applied and implemented. In particular, where special measures are recommended beyond the reach of the arm’s length principle, it seems to us that Article 9 of most treaties would have to be renegotiated in order for tax administrations to be able to implement these special measures.

We are very concerned that the implementation of special measures which are outside the arm’s length principle will lead to an overall surge in instances of double taxation and cross-border controversies. It should be noted that these special measures would be outside the scope of the resolution mechanism of the Mutual Agreement Procedure.

It would be very helpful if the OECD could provide assurances and clear guidance to business that any special measures which are adopted outside the arm’s length principle, will only be a last resort solution and a back up to the guidance in Section D of the Discussion Draft. They should in our view also only be invoked following a good faith negotiation between taxpayers and the tax administrations regarding the application of Section D.

EBIT believes that it is essential to provide clear and unambiguous guidance and assistance to tax administrations as well to allow them to apply the Transfer Pricing Guidelines correctly.

EBIT members trust that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. EBIT is committed to a constructive dialogue with the OECD.

Yours sincerely,

European Business Initiative on Taxation – February 2015

For further information on EBIT, please contact its Secretariat via Bob van der Made: Telephone: + 31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com.

Disclaimer / Copyright: This document contains the collective views of the EBIT business working group and is provided to you courtesy of EBIT. PwC acts as EBIT’s secretariat but PwC is not a Member of EBIT. Nothing in this document can be construed as an opinion or point of view of any individual member of EBIT or of PwC. Any reproduction, in part or in total, of this document, in any form whatsoever, is subject to prior written authorisation of EBIT. Such authorisation can be obtained by EBIT’s Secretariat via: bob.van.der.made@nl.pwc.com.
SUBJECT: DISCUSSION DRAFT ON RISK, RECHARACTERISATION AND SPECIAL MEASURES

6 February 2015

Dear Dr. Hickman,

EY appreciates the opportunity to provide comments on the discussion draft regarding BEPS Action 8, 9 and 10: “Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures)” (the Discussion Draft) as released by the OECD on 19 December 2014. This letter presents the collective view of EY’s international tax network.

General remarks

We are concerned that the draft revisions to chapter I of the Transfer Pricing Guidelines, as well as the special measures that are included in the Discussion Draft, are overly broad and overly vague. We believe that these changes if implemented would create both uncertainty and significant risk of double taxation for global businesses, and would cause a significant increase in the workload of tax administrations to deal with instances of double taxation. The draft revisions and suggested options have implications that extend well beyond the concerns about potential base erosion and profit shifting (BEPS) that are the focus of the OECD’s BEPS project.

We have particular concerns in the revision to chapter I around the introduction of the concepts of “accurately delineating the transaction” for transfer pricing purposes based on the conduct of the parties rather than on the legal basis of the arrangement; of re-determining the allocation of risks based on the conduct of the parties; and of the “fundamental economic attributes of arrangements” test in the section on non-recognition of transactions. These aspects introduce a subjectivity which would allow tax authorities to sit in the chair of the taxpayer, seemingly asking for the “economically ideal” transaction. It implies a complete move away from legal and contractual rights towards the characterization of transactions based on a retrospective view of the conduct of the parties, without providing a clear analytical framework for the analysis. We are concerned if the guidance were finalized in its current form, taxpayers in MNE groups would never be able to achieve adequate certainty over the tax treatment of their transactions with related parties. We urge the OECD to reaffirm the principle that contracts that are followed should be respected, other than in strictly delineated circumstances associated with BEPS.

We appreciate the need to address concerns about the potential for abusive tax planning. However we believe Working Party No. 6 should recognize that it must balance two apparently different objectives for this report: on the one hand, providing practical advice on applying the arm’s length principle with the aim of avoiding instances of double taxation, and on the other hand, arming tax authorities with guidance that in many jurisdictions will become de facto anti-avoidance rules.
These two objectives do not always sit comfortably together, and we believe the OECD should strive to separate guidance on tackling BEPS issues much more clearly from mainstream guidance on applying the arm's length principle.

The draft revision appears to us to be directed at preventing BEPS in certain situations that do not make economic sense, without business purpose and relevant substance, but we see risks that the guidance may have unintended consequences for many multinational groups that are not engaged in such transactions. We are concerned that in practice this may result in double or multiple taxation of the same income. We elaborate on these themes below.

We therefore urge the OECD to allow more time to further discussions and revision before adopting such fundamental changes.

Executive summary / Key comments
Our key comments with respect to the Discussion Draft, as further elaborated upon in the “detailed comments” section of this letter, can be summarized as follows:

• The Discussion Draft covers concepts and situations that go beyond what is needed to tackle BEPS. The proposed revision to chapter I would affect virtually all transactions between related parties, and not just those that create a risk of BEPS as, rather than tackling deliberate profit shifting, it instead redefines the way in which related party transactions are to be analysed, opening Pandora’s box with new levels of subjectivity in interpretation.

• Overall, the Discussion Draft covers the identification of risks in some detail and makes some useful observations but it is missing pragmatism and needs a better defined framework for analysis. Moreover, the Discussion Draft seems to require a disproportionate level of detail with respect to the analysis to be performed and does not envisage a materiality standard of sorts and does not consider that very often this detailed information on what comparables do is not readily available.

• The proposed revisions introduce additional room for subjectivity. This is likely to create additional uncertainty for taxpayers and is likely to lead to increased controversy. Certainly the new concept would create extensive new requirements for documentation of transfer pricing, increasing the administrative burden for taxpayers. If the OECD nevertheless were to decide to introduce such subjective guidance, we strongly recommend the introduction of additional and more effective dispute resolution mechanisms, such as binding arbitration, at the same time.

• The proposed guidance on the actual delineation of the transaction would allow tax authorities to sit in the chair of the taxpayer and recharacterize a bona fide business transaction without further substantiation and outside the circumstances for non-recognition of transactions. In our view it is particularly important for clear thresholds to be established which must be crossed before any re-characterization of the contractual arrangements is possible.

• The general idea of the Discussion Draft appears to be that a requalification of intragroup transactions is made purely on the basis of an economic analysis of the value contributions of the related parties. We believe that such an approach is actually not reflecting the arm’s length principle, but rather qualifies as a subjective economic analysis, potentially with hindsight, of the respective contribution.

• The Discussion Draft seems to suggest an approach in which the role of contractual terms is almost completely abandoned and replaced by an analysis of actual conduct without introducing an analytical framework for it. Transfer pricing analysis should follow the contractual framework unless there is a compelling, objective reason to deviate from it. The OECD should introduce a clear analytical framework/flowchart that describes the analysis: the role of understanding the facts, objective criteria setting out when a tax authority would be allowed to deviate from the contract, how this differs from an actual recharacterization, and when the latter would be allowed.

• The Discussion Draft emphasizes the importance of functions. Many multinationals operate through virtual teams, split over various countries. Furthermore, the composition and location of these teams and the important roles
change on a regular basis. The guidance does not indicate how to deal with such virtual and split teams, and does not indicate how to deal with potential changes. This would create many practical problems for taxpayers.

- Certain comments, e.g. those on interdependencies and moral hazard, could be interpreted as the OECD moving away from the separate entity approach. We recommend that the OECD make a clear statement that this is not the case, and that separation of functions in separate legal entities should be accepted unless compelling arguments for recharacterization exist.

- Transfer of risks and the coherent risk-return trade-off is the basic nature of business in the financial services sector. We therefore recommend mentioning in the draft revisions that the general comments about risk should not be applicable to the financial services sector, since the OECD already published extensive guidance on these topics in the functional analysis sections of the Report on Attribution of Profits to Permanent Establishments. Instead this guidance should be referred to in the context of separate legal entities as well as permanent establishments.

- Before considering special measures, we recommend that the OECD analyze and clarify what failing in the conventional transfer pricing analysis is being addressed.

More detailed comments with respect to the Discussion Draft are presented below. If you have any comments or questions, please feel free to contact any of the following:

Ronald van den Brekel +31 88 407 9016  ronald.van.den.brekel@nl.ey.com
Kenneth Christman +1 202 327 8766  kenneth.christmanJr@ey.com
Ben Regan +44 20 7951 4584   ben.regan@uk.ey.com
Martin Seauve +49 211 9352 21027  martin.seauve@de.ey.com
Michel Verhoosel +27 11 502 0392  michel.verhoosel@za.ey.com

Yours Sincerely,
On behalf of EY

John Hobster / Ronald van den Brekel

Detailed comments

Our detailed comments with respect to the Discussion Draft are presented in the sections below. We focus on what, in our view, are the most fundamental issues addressed by the proposed revisions.

Identifying the commercial or financial relations (section D.1)

The Discussion Draft mentions that it is particularly important to examine whether the actual conduct of related parties conforms to the terms of any written contract. The Discussion Draft seems to suggest a fundamental change compared to the current guidance in paragraph 1.52 and similarly in 9.11 by stating in paragraph 5 that "[w]here conduct is not fully [emphasis added] consistent with contractual terms, further analysis is required to identify the actual transaction." In a dynamic business environment where actual conduct can be changing rapidly, there will be plenty of cases where the actual conduct is not fully aligned with the contractual terms.

The suggested wording is likely to create an environment where the contractual arrangements can be easily discarded by tax administrations and replaced with subjective interpretations based on a retrospective analysis of actual conduct. In the example given in paragraph 6, the conclusion reached is that the transaction in question has been "incorrectly characterised or labelled as a licence [from company P to company S] whereas in fact company S provides services to company P". Paragraphs 10-13 of section D.1 then focus on determining the economically relevant characteristics of the "delineated transaction" in order to determine an arm’s length price. It appears to follow that the process set out in paragraphs 5-6 can
lead to a re-characterisation of the transaction for transfer pricing purposes, apparently outside the circumstances proposed for the non-recognition of transactions (section D.4). Whilst the example given in paragraph 6 may appear clear (in that the parties do not have functional characteristics consistent with the characterization of the transaction), our particular concern is that the guidance does not suggest that any particular threshold must be crossed for a tax administration to determine that an alternative characterization is more appropriate.

In light of the OECD's objectives to secure an appropriate tax base in each jurisdiction and to avoid double taxation, we believe the OECD Guidelines should clearly adopt an approach where the baseline in every case is that contracts which are followed by taxpayers should be respected, unless there are compelling, objective reasons to perform the transfer pricing analysis on the basis of a transaction with different contractual terms (e.g. because clear and substantial differences with actual conduct) exist. The OECD should introduce a clear analytical framework/flowchart that describes the analysis to be performed: the role of understanding the facts, objective criteria setting out circumstances where a tax authority be allowed to deviate from the applicable contract, how this differs from recharacterization, and when would the latter be allowed.

The Discussion Draft seems to require a level of specificity and detail that appears unrealistic and if required, would add a substantive administrative burden to companies with questionable overall benefit. For example, paragraphs 7 and 8 are presented as examples of situations where no contracts exist yet an intercompany transfer of value takes place. The examples seem to suggest that the type of transactions mentioned should have been formalized in contracts and should have been recognized in accounting systems. The reality of multinational business is that many transactions that serve to support key operations are dealt with through intercompany cost allocation systems rather than each being independently recognized and contractually recorded and benchmarked. The outcome of such cost allocation systems need not at all be a violation of the arm's length standard and treating each of these individual transactions as one that ought to be analyzed and benchmarked could lead to a disproportionate administrative burden. In essence, the Discussion Draft seems to suggest that each and every intercompany transaction ought to be subjected to an options realistically available analysis (see paragraph 12). Again, applying such an analysis to a large number of transactions could lead to a disproportionate administrative burden. We believe a materiality test seems in order in this respect.

**Functional analysis (section D.1.1)**

The new and modified paragraphs with respect to the functional analysis seem to focus on the fact that MNEs may be operating in a manner that differs from the way in which independent companies operate. Paragraph 19 mentions that the functional analysis should therefore consider the capability of the parties and how, under the arm's length hypothesis, this could affect the options realistically available to them, and whether similar capability is reflected in potentially comparable arm's length arrangements. We wonder how such interdependencies should be measured / analyzed and how to determine whether certain activities within the MNE are highly interdependent as mentioned in paragraph 21 for example. We are concerned that the proposed guidance in this regard could be used by tax administrations to challenge the structure adopted by MNEs based on subjective assessment of a company's capabilities and capacities. The business decision of an MNE to organize its activities in a certain manner should in our view be respected, unless compelling reasons for recharacterization exist.

In addition, the level of granularity that the Discussion Draft seems to require for the functional analysis and in determining the options realistically available would require information on unrelated party transactions that in many instances will not be available when conducting a comparability analysis. As such, the Discussion Draft leaves the analysis open for suggestions and assumptions by tax administrations that may not be correct, yet hard to counter by taxpayers once asserted, considering the applicable burden of proof allocation.

**Identifying risks in commercial or financial relations (section D.2)**

It is common practice to analyze the risks assumed as part of a more comprehensive functional analysis or comparability analysis. The guidance in this regard in the current guidelines however was fairly limited. Therefore we welcome the fact that
additional guidance is considered by the OECD. However, the Discussion Draft suggests a functional analysis with a level of detail that is potentially much greater than what in most cases is practical for multinationals. Furthermore, although theoretically a detailed comparability analysis as suggested in the Discussion Draft may be preferable, in practice such detailed information will not be available.

**Moral hazard**

The concept of moral hazard can in theory be of value when analyzing the allocation of risk as agreed upon by related parties. It should however be recognized that moral hazard can to some degree occur between independent parties, and that independent parties may to some degree be willing to accept such risk, for example, insurance companies. Moreover, considerations around moral hazard may conflict with the notion that MNEs should not be restricted in the types of transactions in which they engage, so long as those transactions have substance. The concept should therefore not be used to challenge the allocation of risks between related parties merely because the risk of moral hazard exists. Instead, we believe that the concept of moral hazard may be more useful in an analytical framework that describes in which exceptional situations the contractual risk allocation may be challenged by tax authorities. We would also note that the OECD has already published a definition of moral hazard in Part IV of the report on the Attribution of Profits to Permanent Establishments and should ensure consistency across all OECD guidance.

Furthermore, it is important to take into consideration all facts and circumstances when applying the concept of moral hazard in a transfer pricing context. Similar to the observation regarding the functional analysis, the discussion on moral hazard in the Discussion Draft assumes that independent enterprises conduct a perfect analysis of what aspects are within their control and which ones are not, however immaterial, and that they would always act opportunistically with regard of each of those aspects. The discussion seems to aim at disallowing intercompany transactions rather than seeking an arm’s length return for intercompany transactions. For example, one might say that a company engaged in the provision of intra-group services is rewarded for inefficiencies if it earns a mark-up on actual costs (i.e. the higher the cost base, the higher the reward). While such transfer pricing policies may be observed in practice, they are very unlikely to structurally reward inefficiencies in practice, because of internal control mechanisms that are applied within companies and within MNE groups. In practice, the management of the company engaged in the provision of the services is highly likely to be responsible for staying within a certain budget and to minimize the cost incurred in the provision of the services.

We are particularly worried by the statement in the comment box on page 14 that “[b]etween associated enterprises, however, the existence of common control will generally mean that there is no need to contractually align incentives in order to ensure that one party will not act contrary to the interests of the other. Instead, the associated enterprises may operate collaboratively in order to maximize MNE group profits. The adverse effects of moral hazard may in practice not occur.” Reading this in combination with the statements in paragraph 21 on interdependencies, one could interpret this as the OECD moving away from the separate entity approach. We recommend that the OECD make a clear statement that this is not the case, and that separation of functions in separate legal entities should be accepted unless compelling arguments for recharacterization exist.

Moreover, practical experience indicates that the statement from paragraph 67 (i.e. that “[a]rm’s length companies may be unwilling to share insights about their core competencies with third parties for fear of losing intellectual property or market opportunities.”) cannot be confirmed. Unrelated parties in many cases can and do enter into agreements touching on core competencies of one of the parties and transfer core risks to other participants (e.g. many contracts of insurance, including for example those covering product recall, business interruption, professional indemnity, intellectual property infringement, employers liability). Contrary to the statement mentioned in paragraph 67, moral hazard is not frequently observed to play a decisive role in preventing unrelated parties from entering into business agreements. We therefore advise deleting this section of the Discussion Draft.
Risk-return trade-off

The economic concept of risk-return trade-off can be helpful for transfer pricing purposes, for example in the context of business restructurings. The Discussion Draft puts the concept of risk-return trade-off in a rather negative context, e.g. by referring to opportunistic behavior and the manipulation of the discount rate. In our view, the discount rate should reflect the level of risk assumed. When used in a proper way, the risk-return trade-off can indeed be used when valuing intangibles transferred, or to support the economic rationale of a transaction.

The question whether transactions between associated enterprises should be recognized where the sole effect is to shift risk however, seems to be a question regarding recharacterisation and not so much a question with respect to the concept of risk-return trade off.

Financial services sector

Regarding question 8 on page 15, which specifically asks for comments on whether the discussion of risk makes sense for the financial services sector, the response is negative. The OECD spent more than 10 years consulting with the financial services industry, in drafting Part II, III and IV of the Report on Attribution of Profits to Permanent Establishments (July 2010) which sets out many pages of comprehensive guidance defining and discussing risk, capital and functions for the banking and insurance industry. The various sections on functional analysis in the PE reports are not limited to attribution of profits to PE’s only – they contain a detailed description of the banking and insurance industry, which is relevant both in an Article 7 and an Article 9 context. We would therefore recommend that for the financial services industry, this guidance should be applied instead. Furthermore, the respective industries already considered these guidelines in practice. If the concept of risk transfer as included in the Discussion Draft would apply for MNEs in the banking and insurance sector as well, existing arrangements might need to be restructured although they do not entail any risks of BEPS.

It must be noted that transfer of risks and the coherent trade-off of the risk return is the basic nature of the insurance business. The probability of the realization of a risk, where relevant, the control of the potential risks and the moral hazard, are factors applied in determining the pricing of the transfer of risks. However, contrary to other risks which might occur within MNEs, insurers do not control the risk, and often the risk may be outside the control of the insured also. For example neither the insured nor the insurer can control whether an earthquake occurs. Insurers manage the portfolio of the risks, by pooling e.g. through intragroup reinsurances or co-insurance between different MNE members. Insurance contracts are regulated and accounted for as contractual agreements which transfer risk. Where there is no risk transfer, the contract would not be deemed to be a contract of insurance for regulatory or accounting purposes. As indicated in general, for the insurance industry the proposed recharacterisation test would bring subjectivity and uncertainty to the core business.

Considering that risk transfer is the very essence of an insurance business the draft revisions appear to be inappropriate to the financial services sector.

We therefore recommend mentioning in the draft revisions that the general comments about risk would not be applicable within the financial services sector and instead the guidance included in the profit attribution report should be referenced.

Potential impact of risk (section D.2.4)

When analyzing the potential impact of risk, it is in our view important to differentiate between the assumption of risk on the one hand and the actual occurrence of risk on the other hand. The proposed revisions provide detailed guidance with respect to the concepts of assumption, control and management of risk, but are relatively silent on the concept of risks actually occurring. It would be helpful to provide additional guidance in that regard and to acknowledge that the occurrence of a risk cannot be seen separately from the assumption of risk, e.g. in the period prior to the occurrence of the risk or the period afterwards. A company may be in a loss position if risks occur in a magnitude or frequency that was not anticipated or sooner than anticipated. The mere fact that a company does not completely control a risk should not be used to challenge the deductibility of losses or costs incurred as a result of risks occurring. Independent insurance companies, when assuming risk from policyholders, cannot control the occurrence of the risk. In line with behavior that can be observed between
independent parties, members of an MNE should be allowed to make the business decision to assume risks over which they do not have complete control, if the reward includes an appropriate compensation for the assumption of those risks.

Similar to the observations made with respect to moral hazard, the Discussion Draft assumes that independent enterprises will conduct a perfect analysis of what risks are within their control and which ones are not, however immaterial, and that they would always act to reduce that risk. The reality is that certain risks are discounted or overlooked and as such not included in the equation by unrelated enterprises. It is probable that only material risks would merit consideration, yet the Discussion Draft does not envisage a materiality standard and does not take account of the fact that information on what comparables do in this respect is not readily available. We recommend that the OECD include guidance that the analysis of risk should be proportionate to their materiality.

**Risk management (section D.2.5)**

We appreciate the point raised in paragraph 58 that in cases where budgeted costs are used to determine transfer pricing, specific additional attention should be paid to how budgets are determined, and how potential differences or variances between budgets and outcomes are risk managed. However, we believe it is also important to recognize the (practical) value of transfer pricing policies that rely on “true-ups”, for example to mitigate volatility for parties engaged in routine activities. It provides certainty for the parties and tax jurisdictions involved and it avoids cumbersome analyses and disproportionate (and even subjective) fact-finding missions to determine what caused the difference between budgeted costs and actual costs. In particular in cases where the variation is not significant or not significant over a period of multiple years, the value of such a detailed analysis seems limited. We recommend the OECD recognize that a detailed analysis of the difference between budgeted and actual results should only be required in exceptional cases or where the amounts at stake are material.

**Actual conduct (section D.2.6)**

We are concerned that based on the draft guidance, tax administrations may routinely seek to find risks that in their view should be reallocated, or equally likely, to deny deductions in situations where risks have materialized locally, based on relatively subjective determinations of how risks are managed or controlled.

The draft guidance emphasizes that risk management is a function that should be rewarded (for example, paragraph 57), but does not provide clarity on how that function should be rewarded. In some cases (e.g. paragraph 60) the draft guidance suggests that the consequence of an entity managing a risk that is contractually allocated to another entity is that the risk (and its consequences) be reallocated to the entity performing the risk management, so that the reward for risk management is to enjoy the gains or suffer the losses associated with the risk. In other cases (e.g. paragraph 63) the draft guidance suggests that the reward for risk management could be all of the residual profit.

We are concerned that the proposed revisions as drafted seem likely to lead to considerable uncertainty in practice, and we believe the guidance should be amended to make clear that the analysis of risk should be done in a proportionate way, and that the allocation of risk to an entity does not necessarily equate to the allocation of residual profit to that entity.

We are particularly concerned by the example provided in paragraph 63 as it describes a situation that is far more simplistic than most situations that are observed in real life. There may for example be situations where one group company owns assets that are leased out to other group members for the use in their operations. The MNE may have a solid rationale for doing so, in that the assets are frequently moved from one country to another and it is simply not feasible for each group company to own its own pool of assets. The asset owner may not control all risks associated with the exploitation of the assets but, to some extent, may rely on functions performed by other group members. In this case, it seems appropriate to compensate these other group members for their functions performed, rather than reducing the remuneration of the asset owning company to that of a company providing only financing. More generally, reducing the remuneration of an asset owning company in these circumstances ignores the fact that the asset owning company has decided to take on an
investment risk for which it should get a return, and it would ignore the bargaining positions of the parties involved when the asset gets leased.

In addition, the analysis set out in paragraph 63 is of concern since it jumps from identifying the fact that risk management activity is not controlled by the asset owner, to the conclusion that the asset owner should be remunerated with a financing return. This analysis is missing the key step of identifying and considering potential arm’s length comparables. We are aware of companies that passively lease assets to independent parties in the “upstream” sector of the oil and gas industry, where the lessors do not manage the utilization risk of the asset and do not manage the operational aspects of asset use, but nonetheless earn more than a plain financing return.

**Interpretation (section D.3)**

Section D3 introduces a new step called interpretation. The section merely seems to be a summary of the previous sections, and to be looking forward to the section on non-recognition. We don’t understand the value of the intermediate step called interpretation and suggest it be deleted.

**Non-recognition (section D.4)**

Paragraph 85 to 87 elaborate on the possibilities for MNEs to organize their functions, assets and risk in a manner that involves multiple legal entities and to separate contracts, assets or risks into separate entities. As indicated before, we recommend that the OECD clarify that it is not the intention to move away from the separate entity approach. We are concerned that the suggested wording will be used by tax administrations to seek recharacterisation based on the fact that MNEs can organize their business and transactions in a way that differs from the way in which independent parties are organized. We recommend focusing on the key message with respect to the need for recharacterisation to avoid a focus on “circumstantial evidence” such as the use of separate legal entities, etc.

We understand the Discussion Draft is still intending to refer to commercial rationality (as included in the current OECD Guidelines) but is trying to be more objective about the meaning of that term. We are concerned that the wording used in paragraph 89 of the Discussion Draft will have a much broader scope than intended. The proposed wording states that an arrangement exhibiting the fundamental economic attributes of arrangements between unrelated parties would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted basis, compared to other opportunities realistically available to them at the time the arrangement was entered into, and if this is not the case for both parties, then the transaction should not be recognized for transfer pricing purposes. Based on this wording, recharacterization or non-recognition seems possible if for one or more of the parties involved there is any more profitable conceivable alternative, even if the transaction “as structured” is not clearly commercially irrational. This would mean that the outcome of the transaction is subject to subjective economic analysis, potentially with hindsight. It seems to us that it will almost always be possible, with the benefit of hindsight, to identify an alternative arrangement that would have been more beneficial to one or other of the parties, especially because the meaning of “enhancing or protecting the commercial or financial position” of an entity will depend on how broadly one chooses to interpret these terms. Such an approach would actually not reflect the arm’s length principle, but instead will limit the entrepreneurial possibilities of entities within MNEs and will extend non-recognition to areas where no risk of BEPS exists.

We recommend that the OECD clarify that such a strict reference or comparison to the alternatives available is not intended. If a transaction *does* have the fundamental economic attributes of arrangements between unrelated parties, then even if another arrangement (or no arrangement) could (in the view of a tax administration) have better enhanced the commercial or financial position of one of the parties to the actual transaction, that is not sufficient grounds to recharacterize or not to recognize the actual transaction.

1 Bloomberg BNA, Transfer Pricing Report, volume 23, No. 18, page 1211.
Furthermore, we are concerned about paragraph 93 which specifies that the consequences of non-recognition of a transaction are that the actual transaction should be replaced with “[...] the alternative transaction that affords the parties the opportunity to enhance or protect their financial position”. This is in our view a vague concept. Once the actual transaction is set aside, there are numerous alternative transactions that the controlled entities could have entered into, whereas paragraph 93 suggests that there will be just one. This paragraph opens up the possibility of wholly arbitrary and subjective judgments by tax authorities of what “the alternative” transaction would have been, and we foresee great scope for disagreement between taxpayers and tax authorities, and amongst tax authorities, about the recharacterisation of transactions. Overall, given the contentious nature of the non-recognition of transactions, we strongly urge the inclusion of appropriate wording to make clear that the non-recognition of transactions should be a last resort, reserved for exceedingly rare situations. The existing formulation at paragraph 1.65 describing the exceptional circumstances where non-recognition is applicable is in our view preferable to the new guidance.

We plead to coordinate this section with other BEPS actions, in particular Action 6 on treaty abuse, dealing with anti-abuse clauses and Action 14 on dispute resolution.

**Non-recognition (Financial Services companies)**

As noted in paragraph 86, financial services companies do not have the freedom to control shareholdings, capitalization and legal form. Paragraph 86 makes this statement in the context of non-recognition and therefore implies that non-recognition should not be relevant to financial services groups. Financial services groups are subject to regulatory supervision and accounting standards that require the alignment of functions, assets and risks. Therefore we fully support the implication of paragraph 86 and recommend that the OECD explicitly distinguish financial services, as was the case for the Article 7 guidance.

**Special measures**

As a general remark, we believe that introducing special measures raises a risk of double taxation. Separate from a technical discussion with respect to special measures, we recommend having a discussion about how significant this risk of double taxation is, and how it might be reduced. Furthermore, as the arm’s length principle has been largely successful in preventing double taxation we believe exceptions to the transfer pricing system should be narrowly written to address those situations where, for some reason, the arm’s length principle is not being applied successfully. Therefore, we recommend that any description of a special measure would begin with an explanation of why the special measure is necessary (i.e. what failing in the conventional transfer pricing analysis is being addressed). Otherwise, tax administrations may be tempted to apply these special measures merely to expand their tax base which will increase the risk of double taxation.

The special measures in the Discussion Draft in our view do not clearly mention which failing of the existing transfer pricing guidance is being addressed. Because of the potentially fundamental differences between the arm’s length principle and these special measures, we recommend the OECD more clearly describe and define the failings in the transfer pricing system and to first concentrate on clarifying the existing transfer pricing rules to solve this failing. Special measures, if at all, should only be used in exceptional cases. We urge the OECD to extend the amount of time allocated to completing the sections on special measures.

With respect to the particular special measures, we have the following comments:

- **Option 1**: this option bears a strong resemblance to the Commensurate with Income (CWI) standard of the US Internal Revenue Code. We can comment on Option 1 based on experience with the CWI standard. The CWI standard in our experience raises a number of difficult theoretical issues and is difficult to apply in practice. The need for the measure is explained by the necessity to prevent “systematic mispricing”. This wording, as well as the general intention of the measures, shows that its aim is to avoid abusive pricing to shift profits deliberately. The fact that in some cases results are different than predicted does not necessarily prove abuse of intercompany
pricing. Only if forecasts of the parties involved have been deliberately inaccurate, reassessments would be justified. In our view it is very common in business between independent parties to agree on fixed prices and contingent pricing mechanisms are not necessarily agreed upon. It is up to the parties to conclude the pricing on an ex ante perspective, or to include mechanism to reassess the pricing ex post. Therefore, there is no recognizable reason, why such an obligation should be implemented for related parties. Because of these practical difficulties, we recommend against adopting Option 1.

- If Option 1 is taken further, we would urge the OECD to make it clear that any rule introducing retrospective price adjustment or imputing a contingent payment mechanism must be two-sided, so that it could, for example, equally result in an upward or downward adjustment in a future period.

- **Options 2 and 3**: the introduction suggests that these options address the perceived problem that other than in regulated sectors, groups have the freedom to control their structures, including capitalization and creation of entities. We suggest that regulated sectors should be more explicitly scoped out of these measures.

- The introduction implies that certain members of the MNE group are over-capitalized and consequently being over-allocated income. The description of the problem underlying Option 2 is in our view overly broad. It is a special measure that could be applied by almost any jurisdiction to most members of the MNE group. Option 3 seems to assume that a failure in the application of the arm’s length principle has occurred but does not describe the underlying cause. It is therefore unclear what problem is exactly being addressed or which mechanism is used to address the (undefined) problem. Such a vague measure would increase the room for interpretations leading to double taxation.

- **Option 4** is designed to deal with minimal functionality entities. As the Discussion Draft notes “(m)inimal functionality may be the root cause of an arrangement lacking the fundamental economic attributes that normally underpin arrangements between unrelated parties.” Thus, these transactions resemble the targeted transactions described in section D.4 of the Discussion Draft. The fundamental question is why the issue is not adequately addressed by the proposed guidance, as one would expect that minimal income is allocated to minimally functional entities. In the absence of an explanation of the rationale behind this special measure it is difficult to evaluate what transactions should be targeted.

- **Option 5** appears fairly clear that applicability is based on the attributes of the host country of the transferee (low tax rate and, possibly, other attributes) which may be readily determinable. Nevertheless, it is not completely clear what problem with the existing transfer pricing guidance Option 5 intends to address. The fundamental motivation of the BEPS project is to prevent shifting of intragroup income to low tax rate jurisdictions. It is not intended to prevent low taxation of the profits of intangibles originally developed in low tax rate jurisdictions. Measure 5 would equalize the overall taxes of MNE groups irrespective of the functions of the different members. The measure implies that intangibles should always bear a minimum tax of x%. However, it is unclear what would be abusive about the transferee of an intangible asset being in a low tax jurisdiction if the transferee has provided arm’s length consideration to the transferor. In addition it does not seem to be abusive if an intangible has been acquired within the same low tax jurisdiction from a third party. In that case, it is difficult to argue why the acquisition should automatically lead to an inappropriate excessive return. We cannot recommend Option 5 as it would not act to strengthen the arm’s length principle but rather would dissolve it in favor of new instruments to adjust tax assessments.
Paris, le 6 février 2015

Monsieur,

La Fédération Bancaire Française (FBF), organisme professionnel regroupant l’ensemble des établissements de crédit en France, est heureuse de l’opportunité qui lui est offerte de présenter ses observations dans le cadre de la consultation organisée par l’Organisation de Coopération et de Développement Economiques (OCDE) sur le document de discussion relatifs aux actions 8-9-10 du plan « BEPS ».

Ce document fait l’objet d’un certain nombre d’observations de notre part que vous trouverez dans la note ci-jointe, établie en anglais afin d’en faciliter la diffusion auprès des différents membres de l’OCDE et parties intéressées.

Nous restons à votre entière disposition pour tout renseignement complémentaire dont vous auriez besoin.

Je vous prie d’agréer, Monsieur, l’expression de mes sentiments distingués.

Blandine LEPORCQ
Directrice du département fiscal

Monsieur Andrew Hickman
Chef de l’Unité Prix de Transfert
Centre de Politique et d’Administration Fiscale
Organisation de Coopération et de Développement Economiques (OCDE)
2 rue André Pascal
75775 Paris Cedex
Preliminary Remarks

The FBF, as the voice of the French banking sector representing the interests of over 400 banks operating in France, encompassing large and small, wholesale and retail, local and cross-border financial institutions, welcomes the opportunity to provide the OECD with comments on certain questions of the proposed Public Discussion Draft relating to the Actions 8-10 on revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures).

It is crucial for us to have the opportunity to provide our comments as well as our input, particularly given the complexity of certain issues under discussion. We thank the OECD for the consultative process underway and call for a continued interaction with the private sector so that the voice of business is duly taken into account.

As preliminary remarks, we would however like to express some concerns about the “BEPS project”.

The subjects under discussion and the issues at stake are far-reaching and sometimes extremely complex. The accelerated pace planned by Member Countries of the OECD do not allow us to analyse thoroughly the topics, to consult our members as much as necessary and thus do not allow us to contribute as deeply as we would wish to. We believe that analysing the consequences of the proposed changes is also a great challenge for both tax administrations and the private sector, which requires more dialogue and more time. We would therefore call for a more realistic timeframe, with more reasonable consultation periods in particular. It would also be extremely useful to have a track of the different changes brought to the various reports on every action issued by the OECD after collecting the comments of the stakeholders.

On actions 8-10, we would particularly like to stress the fact that although the concepts discussed in the Public Discussion Draft may provide some helpful details which may be of use in certain situations for companies in general, this input seems however less relevant for the banking sector. It does not provide any specific guidance which may be applicable in the banking world; it is noteworthy that many of the examples in the discussion paper are irrelevant for banks notably where risk is discussed (Section D.2.): the very specific types of risks incurred by banks are not addressed at all.

Moreover, the concepts and proposals suggested in the discussion paper, in particular around profit splits and global value chains, have already de facto been taken into account and put in practice by the banking sector when it has had to apply the very comprehensive and detailed set of guidance provided for by the report on Attribution of Profits to Permanent Establishments.

It should indeed be reminded that the situation of the banking industry is a very specific situation, as illustrated by the fact that specific work has been carried out by the OECD with the Report on the Attribution of Profits to Permanent Establishments. This report has categorized two main types of banking activities: (i) Part II (“Banks”) which relates to rather “traditional” banking activities for which “traditional” Transfer Pricing methods would normally apply; and (ii) Part III (“Global Trading”) which pertains to worldwide and integrated transactions on financial instruments for which transactional profit methods may be viewed as more appropriate.
This comprehensive and detailed set of rules has been applied by banks for many years and has led them to carry thorough analyses where concepts such as global value chains are already well known and have been applied with respect to various activities such as financing and trading. Banks have thus secured adequate matching between their operational activities and the attribution of profits.

Consequently, we believe there is no relevance that the banking sector be subject to the proposals of the Public Discussion Draft as they are less adapted and less precise than the ones already applied by banks.
6 February 2015

FFSA’s comments on OCDE public discussion draft on “BEPS Actions 8, 9 and 10: discussion draft on revisions to chapter 1 of the transfer pricing guidelines (including risk, recharacterization, and special measures).”

The French Federation of Insurance Companies (FFSA) is a trade association which groups together 234 insurance companies representing 90% of the French market. In particular, its purpose is the promotion of insurance, the defense of the interests of the profession and the establishment of common ethical standards.

FFSA is supportive of the OECD BEPS Action plans which tackles weaknesses in the international tax environment, and in particular through its action plans 8, 9 and 10, which have the objective to ensure that the genuine substance of transactions is documented and reflected in a group’s transfer pricing policy. Hence, we welcome the opportunity to participate in the consultation process of this OECD draft and we want to focus on the aspects which are the most important for us.

The greatest concerns of the insurance sector is that this draft of guidance takes into consideration the specificity of our sector to ensure that any measures are workable, well targeted and do not result in unintended consequences such as a negative impact on the efficiency of commercial insurance operations and the availability (and cost) of insurance coverage for consumers.
To this end we will focus on the necessity to maintain and upscale a well-balanced, a well-targeted, a clear and stable legal and regulatory framework in the international tax environment (part 1), then on the specificity of the insurance sector (part 2), and to end up, on the special measures proposed in the second part of this draft (part 3).

Part 1: The necessity to maintain and upscale a well-balanced, a well-targeted, a clear and a stable legal and regulatory framework in the international tax environment.

While being supportive of the objective of tackling issues that weakens the international taxation environment, the FFSA is very much concerned about the importance and the broad nature of analysis proposed in this draft. This draft proposes an analysis upon pricing elements of a transaction with regards to the arm’s length principle but it also overwhelms on the economic opportunity of a transaction. For instance, the fact that, a transaction can be disregarded quite easily as highlighted in paragraph 83 and 84 ("D.4 Non-recognition"), and not just reevaluated clearly illustrates this situation.

In addition, the working party contemplates measures which might interfere on the economic opportunity of a transaction, as highlighted in paragraph 88: “The concept of the fundamental economic attributes of arrangements between unrelated parties gives greater definition to the test of commercial rationality which underpinned the discussion of non-recognition in the 1995 and 2012 versions of these guidelines. That commercial rationality test requires consideration of whether the actual arrangements differ from those which would have been adopted by independent parties behaving in a commercially rational manner, but can be challenging to apply since, as the Guidelines themselves acknowledge, controlled parties do enter into arrangements which differ from those adopted by independent parties. That test can be difficult to apply since it is hard to delineate what independent enterprises behaving in a commercially rational manner would have done. In addition, the test can be interpreted as having two legs (commercial rationality and whether the structure adopted practically impedes the determination of an appropriate transfer price) which must be met, as opposed to interpreting the pricing impediment reference as an inherent quality of an arrangement lacking commercial rationality. The two legs can lead to the assertion that if you can find a price, the arrangement is
not commercially irrational, with a resulting emphasis on the quality of the process of
determining an “appropriate” price rather than on whether it is appropriate in the first place to
try to find a price for something which lacks the fundamental economic attributes of
arrangements between unrelated parties”. This “fundamental economic attributes” approach is
to be excluded because it tends to jeopardize the economic choices of companies and accentuates
the risk that the same transactions might be apprehended in different ways, by different tax
authorities and thus increasing the risk of disputes and double taxation.
In short, we support the necessity for tax authorities to understand pricing elements of
transactions between related entities, but this analysis should not switch to the analysis upon the
legitimacy of a transaction.

In addition, there are several aspects in this draft which seem worrying to us, in terms of
unintended impacts that they may cause to the international business environment. We would
like to refer to the remarks of the working party relating to the group approach or economic
family reasoning approach they suggest to tax authorities. This type of analysis is too
challenging for MNEs, because neither an entity within a MNE will have full access to the
relevant information for the counterparty nor a central part of a MNE will be involved to oversee
all transactions entered into between group entities. Hence, considering that related entities have
a group view when undertaking transactions with entities of the group, doesn’t always reflect the
realities of operating a multinational business.

We understand that action 13 was introduced in order to solve transfer pricing documentation
issues through a master file that provides an overview of a multinational group and business, a
local file that provides additional details on the operations and transactions relevant to that
jurisdiction and a country-by-country report that provides summary data, by jurisdiction, with
respect to the group’s income, taxes, and indicators of economic activity. But, there are still
some issues and for instance the necessity of providing useful, relevant and manageable global
information to tax authorities and that does not duplicate information provided in terms of tax
returns and local transfer pricing documentation. And this should be achieved in a cost-effective
and practical way for businesses. Moreover, it is necessary to ensure the confidentiality of tax
and commercial information upon transmission to different tax authorities.
A MNE is made up of several entities. In fact, these entities may have different objectives, strategies and management. In some cases, these entities might even be involved within the same market and competing with each other. And once again, the reasoning of an economic family when analyzing a MNE, does not always reflect the different realities of operating a multinational business.

The working party also suggests tax authorities to focus on the actual conduct of companies: the reasoning should start from the contractual terms but at the same time advocates an analysis on the actual conduct of related parties without any adequate reason. We suggest that an analysis on the actual conduct of related parties, should be made on a complementary basis and only in case of a legitimate doubt of fraudulent behaviors.

**Part 2: The specificity of the insurance sector with regards to OECD BEPS Actions 8, 9 and 10.**

**(A) Specificity of risk in the insurance sector**

FFSA welcomes the objective of this draft which is to ensure that the genuine substance of transactions is documented and reflected in a group’s transfer pricing policy. This being said, we would like to stress on the specificity of the insurance sector with regards to action 8, 9 and 10.

First of all, we would like to emphasize on the highly specific nature of risk in the insurance sector, as highlighted and questioned by OECD working party upon this draft: “*Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made?*”
The working party argues that third parties are unlikely to accept the transfer of a risk, over which they have no control. Unlike other businesses, this argument is incorrect for the insurance sector. The essence of insurance is the transfer of risk between the insured party and the insurance company, concerning a risk over which the insurance company has no control. Another statement made by the working group is that, it is unlikely that a transaction is concluded between unrelated parties in which the sole effect is to transfer risks. Again, this statement does not apply to the insurance sector and in fact it describes the object of an insurance policy. Moreover, in reinsurance business, reinsurers accept risks at a consolidated level without any interaction with the underlying contracts.

Insurance companies cannot control the behavior of their clients, but can strongly encourage or discourage certain behaviors. Indeed, insured parties pay an insurance premium to insurance companies in order to obtain a risk coverage. Insurance companies can charge higher premiums for risk seeking behaviors and lower premiums for risk averse behaviors.

(B) The specificity of a regulated insurance sector.

Moreover, several statements/arguments developed in this draft do not apply to regulated sectors and for instance, the insurance sector.

The working party develops an argument about the allocation of risks and ultimately profits to those having the capacity of accepting the risks, managing it and holding adapted level of capital to cover these risks. And ultimately, this argument suggests tax authorities to undertake an analysis to verify the capacity to perform these functions. This shouldn’t apply to the insurance sector because its high regulation constraints (for instance the Solvency regulation requirements) as highlighted in paragraph 66 “(...) unless subjected to capital adequacy regulations (...)” and paragraph 86 “Except in regulated entities(...) MNE Groups have freedom to control their (...) capitalization (...).” In the insurance and reinsurance sector, the level of capital and solvency are key elements in the assessment of its capacity to accept risks. The determination of the level of
minimum capital and solvency requirements differs from one type of risk to another and from one domestic regulatory system to another. It is thus imperative that tax authorities don’t challenge these highly technical and complex requirements.

Moreover, insurance companies pool their risks in order to spread their risk of loss and to ensure that they hold the necessary capital to cover the volatility, as per the recommendation of their competent regulation authority. In addition, insurance companies diversify their portfolios by writing more business and through reinsurance. In particular, in order to cover their underwritten risks, internal reinsurers may align them with the most adapted level of capitalization.

Part 3: Our remarks to the special measures proposed in the second part of this draft.

Generally speaking about the special measures developed in this draft, we highly recommend that they should be practical and workable. Moreover, we would like to stress once again that the specificity of the insurance sector is taken into consideration in these five options, and in any other special measures. In addition, we would like to recommend the OECD to develop special measures in terms of tax dispute resolving mechanism, with regards to double tax disputes that the measures contained in this draft might lead to.

Regarding option 2 on “Independent investor” and option 3 on “Thick capitalization”, we would like to refer to our previous development on “The specificity of a regulated insurance sector” and once again stress on the necessity to take into consideration the specificity of a regulated sector. The regulatory capital requirements for insurers and reinsurers are generated by solvability regulations and it would be highly inappropriate for tax authorities to question them.

Regarding option 4 on “Minimum functional authority”, we understand that the objective of this measure is to evaluate the fundamental economic attributes of a transactions between related entities, by creating qualitative and quantitative thresholds. Firstly, we would have to refer to our previous development regarding this approach of “fundamental economic attributes” analysis which tends to jeopardize the economic choices of companies. Secondly, we would like to
highlight that there is a necessity for insurers and reinsurers to concentrate their means and capital to be able to meet their commitments. Insurers and reinsurers are already subject to multiple inspections and multiple reporting obligations, with regards to the prudential authorities in every country that they operate. Hence, theses specificities should be taken into consideration in case this option is chosen.

FFSA understands the objective of this draft who is to struggle against weaknesses in the international tax environment. However, we stress on the need to take into consideration the specificity of the insurance sector in terms of risk management and capital requirements, which is crucial for the availability (and cost ) of insurance coverage for the economy. We recommend the working party to take into consideration these specificities, when drafting rules. Measures related to risks should take into consideration the “KERT” approach as per the “2010 OECD Report of the attribution of profits to Permanent Establishment part IV” and measures related to capital should take into consideration the capital regulatory requirements.

Yours faithfully,

François Tallon

Head of Tax Affairs – FFSA
February 03, 2015

Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
OECD

BEPS Actions 8, 9 and 10 Discussion Draft

Dear Mr. Hickman,

The partners of FIDAL’s Global Transfer Pricing Services would like to thank you for the opportunity to present our views with respect to the Organisation for Economic Co-operation and Development ("OECD")’s public discussion draft entitled BEPS Action 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures), released on December 19, 2014 (the “Discussion Draft”).

We have found it quite challenging to respond to this particular Discussion Draft in a way that would be understood as being constructive and proactive. We are in disagreement generally with the direction proposed in the Discussion Draft. It seems to us that the foreseeable results of the proposals are greater uncertainty for both taxpayers and tax administrations and, as a consequence, an increase in the number of cases of double taxation, as well as more difficulties and longer timelines in resolving such cases.

Therefore, if our comments appear somewhat negative, it is because we are of the view that the OECD should consider the opposite direction: that is, we believe that the OECD should (1) promote the general principle of recognition of the transactions as structured by the parties and specifically as outlined in their written legal agreements; (2) restrict the possibility for non-recognition of all or part of the parties’ legal arrangements only in those situations that fall within the ambit of current paragraph 1.65 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the “OECD Guidelines”); (3) prevent other situations where explicit or implicit non-recognition of all or part of the parties’ legal arrangements are already a possibility based on concepts such as “options realistically available” (“ORA”); and (4) avoid the biases and distortions that special measures would introduce into the system of international taxation by upholding the arm’s length principle as the guiding standard for transfer pricing transactions.
The following paragraphs thus offer more specific conceptual comments with respect to the Discussion Draft.

A- OECD Changing the Main Purpose of Its Model Convention

The main purpose of the OECD *Model Tax Convention on Income and on Capital* (the “OECD Model Convention) is “to clarify, standardise, and confirm the fiscal situation of taxpayers … through the application by all countries of common solutions to identical cases of double taxation.”¹ However, since the start of the BEPS project, there is a very vivid concern that the OECD may be silently abandoning this main purpose, replacing it instead with the pursuit of no-less-than single-taxation with severely reduced certainty. This is as a result of the refutation of a legal framework for analysis, as well as the introduction of various concepts whose application can lead to the treatment of a given transaction as if it was a substantially or completely different one.

This trend is particularly visible in the Discussion Draft which affects Chapter I of the OECD Guidelines,² as well as in the changes adopted and proposed with respect to Chapter VI of the OECD Guidelines.

For instance, the Discussion Draft introduces the concept of the accurate delineation of transactions and discusses the (re)allocation of risks as mechanisms which, given their positioning within the Discussion Draft, do not equate recharacterisation (or non-recognition³, as it has been renamed). These mechanisms each contain a feature which effectively results in the potential to disregard the legal agreements actually entered into between the relevant parties. Further, as these mechanisms are not positioned within the non-recognition section of the Discussion Draft, they are not required to be within the criteria necessary for non-recognition as a prerequisite for their application. In other words, the Discussion Draft opens the door for tax authorities to disregard or change the terms and conditions of transfer pricing transactions without defining this as non-recognition, and without having to abide by the limitation that is currently found at paragraph 1.65 of the OECD Guidelines. This will greatly increase the uncertainty with respect to the rights and obligations of parties to transfer pricing transactions, even where such parties have entered into *bona fide* legal agreements.

Furthermore, the loosening of the criteria necessary for the application of non-recognition in the Discussion Draft allows even more explicit recharacterisations of transactions. Thus, between the increased ability for non-recognition found at D.4 of the Discussion Draft and the disregarding of legal agreements performed via the redelineation of transactions and reallocation of risks, the Discussion Draft appears to be dismantling any fiscal certainty that multinational enterprises (“MNEs”) may have built into their transfer pricing affairs by entering into legal agreements.

---

¹ See paragraphs 2 and 3 of the Introduction of the OECD Model Convention.
² The OECD Guidelines should, in theory, abide by the same main purpose as the OECD Model Convention as the OECD Guidelines are essentially an offshoot of the Commentary on Article 9 of the OECD Model Convention (see paragraph 1 of the Commentary on Article 9 of the OECD Model Convention).
³ It is noteworthy that the current Chapter I of the OECD Guidelines contains a section D.2 entitled “Recognition of the actual transactions undertaken” whereas the Discussion Draft replaces that section with one entitled “Non-recognition” (D.4 of the Discussion Draft). Arguably, the change in mindset is found even in the headings used by the OECD.
Similarly, concepts which have been introduced in recent years in various parts of the OECD Guidelines have served to undermine the certainty which would otherwise accompany the use of written legal agreements in establishing the rights and obligations of parties and the terms and conditions of their arrangements. For instance, the concept of ORA is already being used by some tax authorities to price transactions as if they were completely different transactions - even in circumstances that are not business restructurings. It is expected that the concept of transactions that are “economically equivalent”\(^4\) will lead to the same result.\(^5\)

Thus, one might surmise that the OECD has implicitly abandoned the main purpose of certainty embodied in the words “clarify, standardise and confirm” in its OECD Model Convention.

**B- Accurate Delineation of Actual Transactions**

The most troubling aspect of the accurate delineation of actual transactions is that it allows tax authorities to disregard the contractual arrangements between the parties by giving precedence to their “actual” conduct.

This approach might not be objectionable if it was restricted to circumstances where no written agreements exist between the parties, or where recharacterisation is justified under the existing criteria of paragraph 1.65 of the OECD Guidelines. However, because of its positioning within the Discussion Draft, the exercise of accurately delineating the actual transaction leaves the possibility for tax authorities to disregard part or all of a *bona fide* transaction, even when such transaction is covered by a legal agreement, without having to abide by the criteria set out in paragraph 1.65 for recharacterisations.

We know, from experience acquired in respect of the application of the concept of ORA, that some tax authorities already use such an approach to determine the price payable in respect of a given transfer pricing transaction as if it was a substantially or completely different transaction – while simultaneously maintaining that this does not constitute a recharacterisation. It is easy to presuppose that the same result will also happen with the concept of the accurate delineation of actual transactions.

**C- Reallocation of Risks and Moral Hazards**

Similarly to the accurate delineation of actual transactions, the “identification” of risks contained in section D.2 of the Discussion Draft is, in our view, an invitation for tax authorities to reallocate the risks between the parties to a transfer pricing transaction despite their legal contractual allocation. Again, this will only lead to greater uncertainty for all involved, taxpayers and tax authorities, as to the fiscal treatment of actual transactions.

We are also concerned that this reallocation of risks (and general delineation of transactions) might take place based on either assertions and biased assumptions as to what arm’s length parties might or might not do or, worse, in accordance with a pre-determined objective to simply generate a large adjustment in order increase that jurisdiction’s share of the revenue and tax in respect of any given transaction. The OECD should not turn a blind eye to the reality that most governments are trying to

---

\(^4\) See paragraphs 6.112 and 6.129 of the OECD Guidelines.

\(^5\) See also paragraphs 6.70, 6.86 and 6.88 of the OECD Guidelines.
increase their tax revenues and that transfer pricing is perceived as one simple and straightforward way of doing this, even when the initial increase might be curbed back in subsequent dealings either domestically or pursuant to bilateral negotiations via the mutual agreement procedure (“MAP”).

Under the heading “moral hazards” a number of points are raised and questions asked. While we agree in general with the proposition that there might be an issue where one party assumes a risk without having the ability to manage that risk, we are concerned that the proposals contained in this section might be shaped based on artificial assumptions as to what arm’s length parties would do, or based on a view of the limited number of arm’s length observations at the disposal of a given tax authority when reviewing a transfer pricing transaction. To put it differently, we believe that the arm’s length principle should prevail and that, as long as one can either provide arm’s length examples of risk having actually been shared in the manner determined by the parties, or evidence that parties might share the risk in a similar fashion under arm’s length circumstances (via the testimony of industry experts or otherwise), the risk allocation between the parties should be respected.

The alleged “observation” of paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property is an example of the type of bias that may adversely color the drafting of section D.2 and is not necessarily representative of actual arm’s length dealings. For instance, there are numerous well-known examples of companies entering into joint ventures with third parties in certain jurisdictions and providing access to their core competencies and intellectual property. Joint ventures are a good example of parties acting collaboratively, while maintaining separate interests and distinct objectives – and, yes, there is a risk in giving access to one’s intellectual property to a third party, but it does happen in some arm’s length situations.

In applying the arm’s length principle, it is often forgotten that the data publicly available in databases does not represent the exhaustive list of possible terms and conditions upon which third parties may agree. Tax authorities also often operate from the viewpoint that third parties would never part with their so-called crown jewels (i.e. their most valuable business assets). However, even in the public literature, there are examples of third parties entering into transactions that, arguably, could be re-delineated or where risk could be reallocated if occurring between parties not dealing at arm’s length. The OECD also seems to have taken the view that third parties would never enter into an arrangement where a pure owner or financier would be entitled to the residual profits. Actual arrangements between third parties with different objectives and different bargaining power indicate that this is a mistaken conclusion to draw.

In addition, it seems to have been forgotten that arm’s length transactions may in fact result in base erosion and profit shifting. It would be an inappropriate distortion to attack every transaction where BEPS occurs between related parties but leave the same alone if they were to occur between third parties. Thus, there is a distinction between unacceptable BEPS and BEPS which would occur as a natural consequence of arm’s length dealings. In the latter situation, where the same or similar transaction would occur between third parties, tax authorities should not seek to challenge such transactions.
Finally, we note in passing that in practice it may be quite difficult to analyse whether the risks assumed by a tested party are similar to those assumed by arm’s length comparables, unless one is using internal comparables. Thus, we fear that there is a real risk that tax authorities may be tempted to systematically reallocate the risks in transfer pricing transactions in order to bring the terms and conditions of such transactions in line with the limited number of arm’s length transactions where the tax authorities believe that they have an understanding of how such risks are allocated. Again, publicly available data does not comprise the entirety of what arm’s length parties might do, and, such data is usually not available in anything like sufficient detail to truly understand the allocation of risks between the parties.

D- Non-Recognition: Easier to Recharacterise Transactions

As mentioned above, the multiplication of concepts aimed at allowing tax authorities to disregard the terms and conditions as set by the parties to a transaction in written agreements constitutes (1) a further erosion of certainty as it pertains to the rights and obligations of parties, and (2) an obfuscation of clarity in terms of the fiscal implications of their arrangements.

In addition, instead of curtailing recharacterisations that are already occurring, either on a standalone basis, or as the alleged application of concepts such as ORA that do not meet the strict criteria laid out at paragraph 1.65 of the OECD Guidelines, the Discussion Draft allows legal agreements to be disregarded by proposing fewer limitations when using the concept of non-recognition, and none when using other concepts such as accurate delineation or ORA.

This calls into question the viability of the very concept of self-assessment in tax matters: if taxpayers cannot possibly know at the time they file their tax returns whether and how tax authorities will treat their transactions (even if such transactions are covered by written legal agreements), they cannot realistically self-assess with any degree of accuracy. This, in turn, might arguably lead to more penalties, etc. being levied by tax authorities as transactions are disregarded, in whole or in part, or recharacterised for income tax purposes. It also has potentially significant implications for financial reporting purposes.

We are of the view that the first step in the assessment of income taxes is the determination of the legal rights and obligations of the parties and this must be done in accordance with the legal agreements, unless these are found to be shams. The second step in the assessment of income taxes is then the application of income tax laws to the legal rights and obligations of the parties as determined under the first step. We strongly believe that the only way to have certainty in transfer pricing matters is to respect these steps and to only allow parts or all of the terms and conditions of the legal agreements to be disregarded where the current criteria laid out at paragraph 1.65 of the OECD Guidelines are met. In other words, we respectfully submit that the OECD should refrain from allowing further incursions against legal agreements and, instead, should uphold the existing criteria found at paragraph 1.65. Furthermore, the OECD should specifically indicate that resorting to other concepts found within the OECD Guidelines (such as ORA, economically equivalent transactions, etc.) must meet the criteria of paragraph 1.65 if the result is to disregard all or part of the impugned transaction or price it as if it was a different transaction.
The concept of “fundamental economic attributes” (“FEA”) seems to us to be an artificial tool without real practical value, unless one wants transfer pricing transactions to be disregarded and replaced with whatever transaction provides a better tax result in a given jurisdiction. As proposed and outlined in paragraphs 88 and 89 of the Discussion Draft, it appears that, as soon as one can find an ORA which, from a subjective point of view, possibly better enhance or protect a party’s commercial or financial position, then the impugned arrangement could be found to be lacking the requisite FEAs.

The example provided and commented on in paragraphs 90, 91 and 92 of the Discussion Draft is an illustration of an oversimplification of the issues and a singular focus on only one aspect of a given transaction. It is an over-simplification to say that a party might not enter into a transaction simply because that party may have a greater opportunity to enhance or protect its commercial position by retaining a trademark, while disregarding the fact that this party would be foregoing $400 million. If that amount equals or exceeds the value that this party has assigned to its intellectual property, then it seems to us that a party dealing at arm’s length would not readily forego cashing out rather than continuing to manage its intellectual property. Surely, hi-tech companies which sold their intellectual property or their shares in the late 1990’s provide a number of good examples of this.6

E- Special Measures

From a transfer pricing perspective, we are opposed to the adoption of any special measure which would set a hard and fast rule that might depart from the arm’s length principle. Any such measure will cause a distortion in the international tax system resulting in, inter alia, inequalities of treatment between third parties versus related parties.

Experience tells us that such distortions also create opportunities for tax advisors to take advantage of the rule and, consequently, to cause even greater potential for BEPS. These distortions usually become a source of BEPS, no matter how well intentioned and no matter how detailed the drafting of the rule happens to be.

With respect to Option 1 on hard-to-value intangibles, if the special measure is maintained, we suggest that the conditions for rebutting the presumption be linked by the word “or”, not the word “and” as might be inferred from the current wording.

F- Effect on the Mutual Agreement Procedure

If the terms of a transfer pricing transaction are disregarded by the tax authorities of a given State and assistance is requested by the MNE pursuant to the MAP in order to resolve the resulting double taxation, then the two relevant competent authorities will potentially be looking at the same original transaction in a partially or radically different way. This will only make the resolution of MAP cases more difficult, regardless of whether the terms and conditions of the initial transaction by the first State are disregarded on the basis of a formal non-recognition or via concepts such as ORA, accurate delineation of transactions, or other. If the two competent authorities are not starting from a common understanding as to the facts (i.e., from the same characterisation of the transactions), it will take much longer to reach resolution, if a

---

6 One might also think of the more recent example of George Lucas selling the shares of LucasFilm (and thus the rights to the Star Wars franchise) to Disney.
resolution is achieved at all. This situation is not only undesirable for taxpayers; it would be contrary to the aims of the MAP in seeking to eliminate instances of double taxation.

In addition, in the discussion draft entitled *BEPS Action 14: Make Dispute Resolution Mechanisms More Effective* published on December 18, 2014, the OECD recognized that there are issues in eligibility or access to MAP where the adjustments are based on domestic or treaty-based anti-avoidance rules. In some countries, non-recognition takes place via the application of a domestic specific anti-avoidance rule. This thus creates further impediments to the resolution of cases involving double taxation via the MAP. Fewer restrictions in disregarding the legal terms and conditions of transactions, in whole or in part, will result in greater uncertainty which, in turn, will mean a greater number of cases of double taxation and a resulting significant increase in the time needed to resolve such cases as well as, we suggest, an increase in the number of cases found to be unresolvable.

Thus, one of the reasonably foreseeable effects of the Discussion Draft will be a complete congestion of the MAP programs globally. These are already generally strained passed their limits in trying to cope with the existing inventory of double tax cases: they cannot, in their current state, absorb a substantial increase in the annual influx of cases.

As stated in our representations with respect to BEPS Action 14, we believe that the only way to ascertain functioning MAP programs globally is for the OECD to adopt two rules:

- All instances of double taxation must be eligible for relief pursuant to the MAP, regardless of how such double taxation originated; and
- Mandatory binding MAP arbitration must be part of the MAP provisions in the OECD Model Tax Convention (OECD-member countries disagreeing with this clause either post reservations on the relevant provision or observations on the relevant Commentary, and non-OECD-member countries could publish “positions” as is currently done at the end of the OECD Model Convention).

---

7 In Canada, paragraphs 247(2)(b) and (d) of the *Income Tax Act* allow explicitly the recharacterisation of transactions in a transfer pricing context. These paragraphs are considered as anti-avoidance provisions and their use as the basis of adjustment will effectively deny taxpayers access to the full benefit of the MAP (see paragraph 27 of the Canada Revenue Agency’s Information Circular 71-17R5).

8 We also believe that the most efficient way to adopt mandatory binding MAP arbitration and make it enforceable as quickly and efficiently as possible would be to insert such a clause in the multilateral instrument being considered by the OECD under BEPS Action 15.
In conclusion, while we accept that the first aim of the BEPS project was to tackle situations involving less-than-single taxation, we nonetheless believe that this should occur within the purview of the main goal of the OECD Model Convention: to provide certainty in eliminating double taxation. Unfortunately, the Discussion Draft arguably misses the mark on both counts: it increases uncertainty and does nothing to prevent the resulting proliferation in double taxation that it will generate by allowing tax authorities to disregard the legal and contractual rights and obligations entered into between members of MNEs. In turn, the uncertainty generated by the proposals in the Discussion Draft will lead to significant increases in terms of both processing time and number of unresolvable cases in the MAP programs globally.

Best regards,

François Vincent  
GTPS Partner

Pascal Luquet  
GTPS Partner
Comments on the Public Discussion Draft of BEPS Actions 8, 9 and 10: Revisions to Chapter 1 of The Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures).

To: Andrew Hickman, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration (TransferPricing@oecd.org)

Introduction

The OECD released its latest draft on the public discussion of new concepts on recharacterisation of transactions 17 December 2014 with comments invited by 6 February 2015. The comments provided below are prepared by the author as representative of Gazprom Marketing & Trading Ltd.

General Overview and High Level Concern

Historically the OECD have followed the approach that recharacterisation of a transaction is a last resort. The current approach is that the legal agreement/form is the starting point of any analysis, which is usually followed by an economic analysis. There are only a few circumstances where it would be appropriate and legitimate for a tax authority to exceptionally disregard or re-characterise a transaction. Those are if the economic substance differs from its form, if the arrangements viewed in their totality would not have been adopted by independent enterprises or in extremis if the arrangements are a sham.

We can understand and support the intent of the OECD and BEPS to align transfer pricing outcomes with value creation and to a large extent this proposal provides further guidance on those exceptional cases which may warrant re-characterisation.

However, the current draft represents a significant shift in this approach and results in reducing the threshold for tax authorities to re-characterise a transaction beyond just those exceptional cases. It provides much greater flexibility to tax authorities to disregard a genuine and commercial intercompany transaction and re-characterise it in a manner that is more favourable for them. This seems to be a theme throughout the BEPS initiative of generally lowering the threshold for taxation.

We see this, and re-characterisation of transactions in particular, as a dangerous step which creates significant uncertainty for taxpayers and the likelihood of double taxation.

The existing guidance correctly notes that “restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequality of which could be compounded by double taxation”. That concern remains completely valid. The existing guidance already provides adequate opportunity for tax authorities to challenge the exceptional and rare cases of artificial transactions and we therefore question the need to change that. If the OECD can demonstrate that there is a clear need to expand the guidance then it needs to ensure that it does not result in arbitrary and unfair outcomes, which the OECD itself warned against, for the vast majority of innocent taxpayers.
The options outlined in Part 2 of the draft are even more concerning. These would generally see a departure from the arm’s length principal and over-ride that with an arbitrary allocation of capital, assets and profits on the basis that a tax authority doesn’t like the arms length outcome under the general guidelines. These ignore the underlying principals of taxation and are actually contradictory to a key BEPS aim of aligning profits with economic substance. As such we cannot see how some of these options can be justified.

**Revisions to Chapter I of the TP Guidelines**

*Identifying commercial or financial relations (Delineation)*

Whilst the principles outlined are generally reasonable, our main concern is the threshold for re-characterising a transaction. Currently it is explicit that re-characterisation, either due to the economic substance differing from the legal form or from a transaction as a whole being considered uncommercial, should be used exceptionally as the result of doing so can be arbitrary and unjust. The new draft in effect splits these two scenarios into “delineation”, i.e. where the economic substance differs from the legal form, and “non-recognition” for uncommercial transactions. To be clear both of these are in effect re-characterisation.

However, in the case of delineation there is now no mention of this being the exception and in fact it would appear that the OECD considers this would be the norm. The proposal significantly shifts the position in favour of tax authorities by assuming that any intercompany transaction can be artificially structured to avoid tax and can therefore be recharacterised. Recharacterisation is the most powerful and dangerous tool for tax authorities and therefore needs to be used with caution and in only in those real cases of tax avoidance – for example in respect of a sham transaction. Tax authorities should not be able to freely re-characterise any transaction and there has to be some requirement to show the presence of tax avoidance before being able to recharacterise a transaction. Even where States have existing substance over form provisions (e.g., in local GAAR etc.), it is typically subject to a tax motive/avoidance test.

This is even more important because of the potential quantum of adjustments and double taxation in recharacterisation cases. There is already difficulty in reaching agreement in a simple case where two tax authorities may have a different view on the appropriate mark-up or profit share on a transaction. This will be exacerbated when the two authorities can then each start to recharacterise the transaction in different ways and the divergence in results can quickly become very material. This has been seen in cases where recharacterisation has been used and is compounded when there is either no ability for mutual agreement or where agreement cannot be reached.

In terms of the principles, if this was instead positioned as additional guidance to identify those exceptional cases then, we would generally agree with many of the comments. The two step concept which refers to delineation of transaction between related parties and then comparison of the arrangement with similar unrelated arrangement is in line with the common practice and general concept followed by the Guidelines.

The draft does not recognise the fact that related companies often enter into arrangements that may not be met between third party companies which are in themselves economic transactions but may be difficult to obtain comparables. This is because economics of a contemporary MNE strongly
relies on specification of various functions and various synergy effects that are achieved when all transactions are considered in combination. In addition it has to be recognised that taxpayers will have no visibility as to how comparable companies are organised in terms of functions, assets and risks and therefore delineating a transaction away from the legal form makes it even more difficult to find a reliable comparable.

**Identifying risks in commercial or financial relations**

We broadly agree with the concepts suggested in the section. It is generally reasonable to consider how the risk is managed as well as the contractual risk taker. However, that is not to say that where the two are different there is not a commercial reason for that. The reasons for segregating risks therefore need to be considered. Similarly there are valid commercial reasons for transferring risk within a group, which would include aligning it with centralised risk management.

The draft recognises that risk will be managed at different levels and that different functions may be involved in managing the risk. It is not reasonable to start allocating various risk returns across those entities and should instead focus on the primary function managing that risk. For example in Para 46/47 it assumes that price risk is managed by the production entity as it can stop its production if prices fall too low. In reality there would be at least a level of senior management that considered future commodity price risk when investing in that business. Day to day the price risk is then more likely to be managed by the sales company who can hedge the commodity price, enter into forward sales etc. Simply stopping the production is likely to be a last resort and is not really “managing” the risk.

The draft also makes reference to how the group manage the risk. However, just because one company may manage a risk in a different way should not mean the transfer pricing is different. Taking again the example in Para 46/47 above; two groups with the same production activity, Group A chooses to hedge the price risk with derivatives and Group B doesn’t. Group A would likely hedge in the sales company and pass that on to the production company in terms of fixed prices (rather than variable spot prices). Whilst Group B has chosen not to hedge and face the price fluctuation that is not to say they shouldn’t be able to use a similar fixed price at an intercompany level to put Group A and B in the same tax position.

The draft also purely focuses on how a risk is managed and remunerated and ignores the essence of a risk which is the downside. It must follow that if a person is allocated a return for managing a risk as opposed to the legal owner of the risk, then it should also bear the cost if that risk materialises. Tax authorities are quite happy to argue not compensating an entity for bearing risk but will equally argue any losses belong to the person with the legal risk when they arise.

**“Non-recognition”**

The scope to disregard a transaction which lacks fundamental economic attributes is more in line with existing practice and is a far more reasonable approach. It notes that non-recognition is only appropriate in “exceptional circumstances” and under “strict criteria”. It also acknowledges that non-recognition/recharacterisation is contentious and a source of double taxation. In our view the same should be applied to recharacterisation via delineation in the preceding sections.
The chapter explains the necessity of non-recognition itself as “there is no limit to the number of legal entities in an MNE group, and a group could, and sometimes does in practice, put individual contracts, assets, or risks into separate entities”. We would note that such considerations are usually due to commercial considerations and are not tax driven. Additionally, many MNE’s do not act as a single controlled group and can have degrees of independence which means that negotiations between related parties often already have all the attributes of negotiations between unrelated parties. Therefore, the application of the measure is disproportional to the limited cases it is likely to apply to.

The suggested test of non-recognition in the draft is based on a single test of the commercial rationality of a transaction, or the “fundamental economic attributes of arrangements between unrelated parties”. The OECD admits that the test can be quite difficult to apply, as transactions within MNE’s may be quite unique. Bearing in mind the subjective nature of the commercial rationality test, we foresee that such an approach can lead to differing views across countries whereby one may disregard and another may not or the two may have different views of the alternative transactions “that affords the parties the opportunity to enhance or protect their commercial or financial position”. It raises issues around how tax authorities can make such commercial judgements, how will you determine what enhances or protects value and what if there are multiple alternatives?

Therefore, we would suggest that non-recognition is supported by other additional criteria, such as tax avoidance motive test. In addition to that, in order to mitigate the risk of double taxation, we would welcome a measure whereby recharacterisation may only be possible if tax authorities in the jurisdictions involved agree on the alternative treatment of a transaction. Given that re-characterisation creates significant risk for MNE, such measure would offer at least some level of protection from unjustified challenges and significant cases of double taxation.

Specific Recharacterisation instruments

**Hard to value intangibles**

Long term agreements are extremely common between third parties. Companies enter into such transactions based on their own assumption of future developments of events, their strategy, risk appetite, etc., even though conditions around the deal may change constantly putting either party in a better or worse situation. The main purpose of a long term agreement is to fix the arrangement so that both parties can plan their investment accordingly, without the option to immediately change the agreement if the circumstances change. This fact is overlooked in the proposal as it assumes that the parties may reconsider their arrangements based on the outcomes and market situation, disregarding their original agreements.

If two parties have agreed to sell an asset at a fixed price, the price should be determined by the factors prevailing at that point in time. That is different from parties agreeing to a buy-out clause or similar arrangement which is subject to future results. These are completely different transactions commercially, have different implications and should be priced differently. To simply add a price adjustment to the first scenario results in a fictitious hybrid that is not a realistic commercial outcome and, hence, is not arm’s length.
Where the parties have agreed a fixed price it is reasonable to expect the taxpayer to be able to provide contemporaneous documentation of that price. However, tax authorities should only be able to challenge the pricing based on the reasonableness of the assumptions and facts at that point in time, and should not be prejudiced with the benefit of hindsight that would not be reflective of the factors prevailing when the price was agreed. Would the tax authorities be equally willing to reduce a fixed price if a taxpayer came along and showed that based on subsequent events and hindsight it was too high?

Whilst the proposal specifically focuses on intangibles, the same principals can equally apply to valuing tangible assets, trading contracts etc. which have an uncertain income flow. It therefore needs to be considered within the definitions and scope whether these would also be included or not.

Finally, we would once again make the point that in practice all intangibles are “hard to value”. Therefore in practice all intangibles are likely to be caught by these proposals.

**Inappropriate returns for capital**

The proposed general guidance already moves the focus from the mere legal ownership of an asset to the functions that are actually performed in managing that asset. We do not see why the proposed general guidance does not address the allocation of excess returns to assets and it would be helpful for the OECD to provide examples for discussion.

Without the aid of any examples, the proposal in Option 2 to begin deeming contributions of capital and deeming ownership of assets to other entities is an unnecessary and dangerous path to take. In addition to the potentially non-arms length outcomes, deemed capital contributions and distributions often come with other tax implications of capital taxes, wealth taxes, withholding taxes etc. Therefore, thorough analysis and consideration is required of the situations this may apply and all of the associated tax implications in order to justify such an approach.

The other scenario of a parent company choosing to invest in an asset through its subsidiary is equally unclear. Depending on the type of asset, the company may be subject to tax in another country if it gives rise to a PE there. The subsidiary country itself then has the right to tax the profits under local corporate tax and also to apply a withholding tax on the distribution of those profits to the parent. The parent country has the ability to tax a transfer pricing return for any functions it performs in managing that asset, to impose a CFC apportionment on the subsidiary profits and to tax the dividends received from the subsidiary. Are six opportunities to tax not sufficient without creating another rule whereby the parent could be deemed to own the asset directly?

In regards to Option 3, it is not clear how this corresponds with the principles described in Action 4 on interest deductibility. This is not the only scenario where the OECD are at risk of creating a myriad of conflicting proposals, in this case by attempting to disallow interest on one hand where a company is considered to have too much debt and then on the other hand deeming interest if it has too much equity. It seems that the OECD consider both debt and capital as simply tools for tax avoidance and would like to prescribe the capital structure of every company. In practice capital requirements for different industries vary significantly and even within the same industry capital requirement depend on various factors, such as company strategy, its key functions and risks.
assumed, economic situation, market situation, etc. Bearing all these factors in mind, such an approach is technically unjustified and practically impossible.

**Minimal functional entity**

The proposal would be to reallocate the entire profits of a company if it is considered to have “insufficient substance” by reference to some, yet to be defined, subjective and arbitrary definitions. It attempts to justify this on the basis that is simpler than undertaking the correct analysis of each arrangement and applying the appropriate transfer pricing and benchmarking to those individual arrangements. The concept of minimal functional entity with a profit split based on predetermined criteria is a step away from arm’s length principle and towards formulaic allocation principle which we would strongly oppose.

**Appropriate taxation of excess returns**

This is a wholly unjustified approach to taxation and is again a significant step away from arm’s length principle. Firstly, the primary rule depends on some arbitrary tax rate which is considered to be too low and an arbitrary definition of profits which are too high. It would also only exclude income from a CFC’s own country whereas it is common for commercial reasons to have one entity making sales into several countries. It is not practical to set up an entity in every country you make sales. The prevailing principle is that the sales should be taxed in the country where the sales functions are actually performed, CFC rules should be consistent with that.

In addition, the secondary rule bears no relationship to where a company is doing business and making profits. This is completely contradictory to a key BEPS objective of aligning profits with economic substance and would create a wholly arbitrary allocation of profits. It is in effect akin to ignoring all the principals of taxation and simply allocating a multinationals profit across each company/country on some pre-determined allocation.

Take for example a CFC operating a low tax jurisdiction, the CFC has significant local presence and operates there due to it being a recognised industry hub which provides access to staff, resources, support services etc. and is close to the local sales markets. The CFC itself is subject to tax at a rate that country sets as appropriate and is also potentially subject to tax in any country it operates which gives rise to a permanent establishment. Each of the group companies involved in the value chain could face a challenge for transfer pricing and in addition each of the countries in the ownership chain can tax those profits either under a CFC rule or when distributed under dividend taxation. The fact that even after PE, TP and CFC rules, the profits have not been taxed elsewhere should in itself show that the profit is rightly attributable to the CFC. Just because they have been successful in making profits and earn an “excess return”, why should they then allocate that profit across other companies who have no right to it? Would “excess returns” in a high taxed CFC be exempted from tax under similar principals or re-allocated to lower tax countries?

We trust the forthcoming discussion draft on Action 3 will have a more thoughtful proposal on guidance for CFC rules. This area should be left to Action 3 and at the option of States as to how to implement CFC rules and in our opinion has no place in transfer pricing guidelines.
Conclusion

We appreciate the effort that OECD is making to target artificial structures and avoid double non-taxation. However, we believe that the Draft paper on recharacterisation represents a very dangerous instrument in the hands of tax authorities that can be used by any local authority depending on their subjective treatment of economic transactions.

We suggest that the approach to recharacterisation should not be as broad as it is currently described in the Draft. In fact, quite the opposite, usage of recharacterisation paragraph should remain a last resort method that should only be applied if there are strong indications that a transaction is artificially structured to avoid or evade taxation.

The other options suggested by the OECD all seem to suggest introduction of certain criteria, ratios or standards, which would draw a red line between what is arm’s length and what should be re-characterised. This approach goes against the principle of arm’s length itself, as it does not take into account various factors of comparability.

These comments have been prepared by:

Tim Branston - Director of Global Taxation
Gazprom Marketing & Trading Ltd
20 Triton Street
London, NW1 3BF

E-mail: tim.branston@gazprom-mt.com
Web: www.gazprom-mt.com
GFIA Comments on OECD Discussion Draft on BEPS Actions 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk recharacterisation, and special measures)

Introduction

The Global Federation of Insurance Associations (GFIA) through its 38 member associations represents insurers that account for around 87% or more than $4 trillion in total insurance premiums worldwide. GFIA is pleased to provide comments on the OECD discussion draft on BEPS Actions 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk recharacterisation, and special measures) (the “discussion draft”). In general, the GFIA supports the objectives of the OECD BEPS Action Plan to address weaknesses in the international tax environment. Accordingly, the GFIA supports the broad objectives of the discussion draft to ensure that the genuine substance of transactions is documented and reflected in a group's transfer pricing policy, rather than the legal form. However, it is critical that any measures adopted by the OECD are workable, well targeted, and do not result in unintended consequences that negatively impact the efficiency of commercial insurance operations and the availability and cost of insurance coverage for consumers. In particular, given the highly regulated nature of the insurance industry, particularly with respect to capital requirements, any changes affecting capital would have a negative impact on the availability and cost of insurance, given the importance to insurers of being able to diversify portfolios through reinsurance.

General comments

The GFIA agrees that comparability is at the heart of the arm’s length principle, and that the accurate characterisation of transactions together with identification of comparable transactions between unconnected parties is essential. The GFIA welcomes the guidance set out in Part I of this document in terms of understanding what best practice might look like.

The GFIA believes however that some considerations presented by the discussion draft do not apply to the insurance industry. The GFIA believes that the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) (“Part IV”) continues to be relevant to the discussions about transfer pricing and the allocation of risk in the highly regulated insurance context. Referencing Part IV would be the best approach to providing guidance on risk transfers for the insurance industry, given the time and effort which has already been invested in the development of Part IV and the very tight time constraints in finalizing the BEPS initiatives.

Any discussion about risk and capital in insurance should take into account the fact that regulators in all jurisdictions require insurers to hold an appropriate amount of capital in order to ensure that policyholder claims can be paid out in all circumstances. The precise amounts depend on the regulatory regime in question. But in
all situations this is the minimum amount of capital that would be held by the insurer. In addition to regulatory capital requirements, ratings agencies impose additional conditions to satisfy credit rating requirements. For insurers, the rating applied is also critical as certain types of investors may only be able to invest in entities with a prescribed credit rating or higher. Therefore, the maintenance of an appropriate level of capital within a jurisdiction is not a business choice, open to flexibility depending on the tax treatment of debt but instead it is critical to an insurer’s ability to carry on business. Insurers typically hold additional capital in excess of the minimum capital amount as a buffer. The tension between the flexibility of this approach in writing business and paying out claims versus the cost of holding capital of sufficiently high quality such that it qualifies as regulatory capital is something that insurers constantly have to manage. The ability to manage capital efficiently is a key source of competitive advantage in the sector.

**Specific comments**

**Question on page 15** regarding the Financial Services Sector & On-going Relevance of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance)

Page 15 of the discussion draft raises the following question with respect to the financial services sector: *Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?*

The GFIA has a number of concerns regarding some of the comments made by the discussion draft. Our concerns relate to the extent to which these considerations apply to the insurance industry.

For example, the discussion draft notes that: *Between third parties, the assumption of risk without the control exerted by management over the risk is likely to be problematic because (i) it is difficult for the party assuming risk to evaluate the required additional expected return when the factors affecting the risk outcomes are determined by another party; and (ii) there would likely be considerations of moral hazard in an arm’s length situation were one party to assume risk without safeguards to manage the behaviour of the party creating its risk exposure. In arm’s length transactions it generally makes sense for the parties to be allocated a greater share of those risks over which they have relatively more control."

This does not hold for insurance since, unlike in other industries, insurers do take on risks over which they do not have a lot of control and this is fundamental to the insurance business. Insured parties pay an insurance premium to reduce their exposure to risks; the insurer pools the risk to distribute the contingency of loss and holds the necessary capital to cover any volatility. The insurer prices the contract to reflect the risk level (higher premiums indirectly encourage the insured to manage and reduce the risks where possible). Insurers manage their risks by diversifying their own portfolios, by writing more business and/or through reinsurance (which effectively provides insurance to the insurance company). The statement that parties should be "allocated a greater share of those risks over which they have relatively more control" is not applicable in the insurance industry. Instead, risks should be allocated to the parties capable of accepting and managing the risk and who hold sufficient capital to cover the associated volatility.
Part IV recognizes that the KERT for insurers is the assumption of insurance risk/business (see for example paragraphs 93\(^1\) and 94). Part IV provides comprehensive guidance defining and discussing risks, risk management and allocation of risk in the context of insurance businesses. Accordingly, referencing Part IV would seem to be the best approach to providing guidance on risk transfers for the insurance industry, especially given the time and effort which has already been invested in the development of Part IV and the very tight time constraints in finalizing the BEPS initiatives.

Paragraphs 88-93 discuss the effects of non-recognition of a transaction. The GFIA does not see the added value of this solution as it creates a lot of uncertainty for taxpayers. In the GFIA’s view, the current set of rules and proposals should be adequate to establish the correct price. The issue of the example made in paragraphs 90 and 91 could be resolved by adjusting the royalty payment to reflect the functions performed, risks taken and assets used without fully discarding the element of capital put in the equation. The GFIA believes that tax authorities should only make use of this instrument as part of a direct consultation between the tax authorities that could be linked to a mutual agreement procedure. In particular, paragraph 93 deals with consequences of non-recognition and seems to suggest that a new functional analysis has to be made of the transaction, which raises the question what the added value of a non-recognition would be in the first place. Specific consideration should be given to dispute resolution mechanisms.

Generally, much of paragraphs 43-59 which discuss allocating, assuming, and managing risks and the potential impacts of risks are not relevant for the highly regulated insurance industry. Accordingly, the GFIA welcomes the following comments:

- **Paragraph 66:** "MNE groups, unless subject to capital adequacy regulations, can determine the capital structure of subsidiaries without explicit consideration of actual risk in that subsidiary. For the same reason, a low level of capital in a controlled enterprise should not prevent the allocation of risk to the company for transfer pricing purposes where such allocation is justified under the guidance of this Chapter." (emphasis added)

- **Paragraph 86** which notes that regulated entities are subject to significant restrictions such that they do not have "freedom to control their structures, including shareholding, capitalisation, and legal form".

With respect to paragraph 66, the GFIA also notes that the last sentence is not applicable in the highly regulated insurance context, since enterprises with a low level of capital will not have sufficient regulatory capital to accept additional risk.

---

\(^1\) Paragraph 93 of Part IV states in unequivocal terms: *All facts and circumstances need to be considered to determine which function assumes insurance risk for the enterprise, because the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise. Other functions performed by an insurance enterprise may be important and valuable functions and should be compensated accordingly, but these other functions are not functions that form part of the key entrepreneurial risk-taking function.*
Paragraph 67 states: "Third parties may be unlikely to provide insurance for core competencies unless they have significant information about and control of potential outcomes due to moral hazard that the incentive to manage risk by the insured party is lowered."

This statement is not applicable for insurers as they do provide insurance for core competencies (for example professional indemnity insurance as well as the reinsurance market) although the price charged will reflect the level of risk assumed and may also be dependent on risk management activities in the insured entity. However, any insistence on such risk management activities is likely to fall short of "significant information about and control of potential outcomes". The GFIA suggests that this sentence be amended to make it clear that it does not apply to the insurance/reinsurance industry.

The final sentence of paragraph 78 states: "A party which does not control risk will not be allocated the risk and therefore will not be entitled to unanticipated profits (or required to bear unanticipated losses)."

As mentioned previously, in the insurance context, the insurer generally does not control the risk, but instead prices for the level of risk assumed. As noted in Part IV, risk assumption is the KERT for the insurance industry, and as such, the insurer would therefore be "entitled to unanticipated profits (or required to bear unanticipated losses)".

Retrospective Approaches: The GFIA is concerned that the discussion draft includes a number of cases where retrospective reviews of arrangements are noted. Third parties enter into transactions based on the information available at the time, which is consistent with the existing Transfer Pricing Guidelines. If the actual results are different from the expected results, which would often be the case, third party contracts are not generally revised retroactively, rather they are renegotiated on a go-forward basis (assuming both parties are in agreement). Accordingly, the GFIA has strong concerns that retrospective approaches will not produce results consistent with arm's length transactions. Furthermore, such approaches would generate a fiscal result different to that arising for regulatory, contractual and accounting purposes. A retrospective adjustment to an arm's-length transaction would expose an individual insurance company to an unexpected tax charge that would suddenly deplete its regulatory capital and potentially impair the ability to pay legitimate claims to policyholders. The GFIA thus recommends that any adjustments for additional transactions should be limited to situations where there would be adjustment in transactions between third parties.

Paragraph 7 discusses unidentified MNE transactions which result in a transfer of value between parties. Explicit reference is made to a provision of know-how via a seconded employee. In the GFIA’s view, it is virtually impossible to make a distinction between deploying the skillset of an employee for the benefit of the host country business (like any other employee) and a transfer of know-how for transfer pricing purposes. The same effect would likely be obtained by hiring an individual from say a competitor (i.e. the transfer of know-how is reflected in the remuneration of the individual). The GFIA would therefore welcome a further clarification on this example.

---

2 For example, see paragraphs 5 and 7 of the discussion draft.
Paragraphs 12-14 describe the manner in which independent enterprises decide whether or not to enter into a specific transaction. This implies that an enterprise can compare and freely choose between service providers, making a distinction between them on the basis of (for example) prices. This however might not always be the case in an MNE, where certain services may be centralised and provided at a cost level which is considered normal in country X, but lies above the cost level which would be normally acceptable by a member of the group resident in country Y. In other words, commercially, the transaction adopted may not always be the best opportunity for the service recipient.

Clarification Regarding Insurance Comments in Paragraph 18

Paragraph 18 includes the following insurance example: “18. [New] In other situations, the controlled arrangement may require reduced capabilities to what might typically be required in uncontrolled arrangements. For example, an independent insurance provider offers diversification that the party seeking insurance may not have. However, in a group situation, the group may already have a wide range of assets in a range of locations such that some of the value of diversification that is implicit in the insurance premium charged by an independent insurer is already provided by the group companies. The additional capabilities the group may have in this situation will likely lead to a different fee to that charged by an independent insurance company to a customer lacking such attributes.”

It is not clear what point this example is trying to make so the GFIA would suggest that it be deleted. For example, is it suggesting that there would be a group volume discount i.e. that if the whole group purchased insurance from the same insurance company (or under a global master policy), it would be cheaper than if each company purchased insurance individually? For full geographic diversification, the assets would need to be in different countries. In that case, due to regulatory restrictions, each risk would likely be insured by a local insurance subsidiary, so pooling benefits of geographic diversification would be minimal, and would only be achieved to the extent the insurance group subsequently reinsured the risks centrally to another group company.

Response to Question 4 on Page 14: Under the arm’s length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognised, how should they be treated?

The fundamental nature of the insurance industry is to shift risk. Accordingly, insurance and reinsurance transactions between associated enterprises should be recognised (and be priced on an arm’s length comparable basis).

Special Measures

In general, the GFIA believes that clear criteria for the application of special measures need to be established, so that the measures can be applied consistently by tax authorities. Special attention needs to be given to devising a mechanism which eliminates the potential of double taxation in situations where transactions/entities are caught and tax has already been assessed in the other jurisdiction.
- Option 1 introduces retrospective tests and steps away from the arm’s length principle. The GFIA believe that if initial arrangements took account of all information available at that time then no subsequent adjustment should be made in the event that the actual results differ from the budgeted results.

- Option 3: Thick Capitalisation would not be appropriate in the highly regulated insurance sector where regulators already require insurers to hold sufficient capital to protect policyholders and ensure the on-going viability of the business.

- Option 4: Minimal function entities. The GFIA agrees that to be viewed as a minimal functional entity the “company in substance performs mainly routine functions”, but the GFIA thinks that statements about the number of employees introduce confusion. The GFIA would suggest that the drafting of the measures should be such that it is clear that no one qualitative or quantitative measure alone should be a decisive indicator of minimal functionality. The test of minimal functional entity should recognise that:
  
  - Many insurance groups have single employer entities in their head office and main operating locations, typically due to regulatory constraints or preference and/or reasons of employment law and operational efficiency. Functions are often performed internally and are then supplied by arm’s-length agreement to the receiving entity. There is a genuine function performed, but the employer entity is different for non-tax reasons.
  
  - Certain functions may be outsourced to cheaper developing countries, in order to obtain the cost efficiencies which ensure basic insurance premiums remain competitive. Such activity should not then be penalised by the application of a minimal function entity adjustment. The GFIA recommends that these outsourced employees be included in the test as performing the function they actually undertake.

- Option 5: Ensuring appropriate taxation of excess returns is more a CFC rule than a transfer pricing one and the GFIA does not believe that transfer pricing actions could prevent excess returns in low tax jurisdictions. The GFIA suggests this issue can be better addressed under Action 3.

---

**GFIA contact**
Peggy McFarland, chair GFIA Taxation Working Group, pmcfarland@clhia.ca

**About the GFIA**

Through its 38 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 58 countries. These companies account for around 87% of total insurance premiums worldwide. The GFIA is incorporated in Switzerland and its secretariat is based in Brussels.
Andrew Hickman
Head of Transfer Pricing Unit
OECD Centre for Tax Policy and Administration
2 Rue Andre Pascal
75755 Paris Cedex 16
FRANCE

3 February 2015

Dear Andrew,

**OECD public discussion draft - BEPS Actions 8, 9 and 10: Revisions to Chapter 1 of the Transfer Pricing Guidelines**

Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft entitled *BEPS Actions 8, 9 and 10: Discussion draft on revisions to Chapter 1 of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures)*, issued on 19 December 2014. Our comments are set out below. We very much welcome the sharing of this early draft for comment, and the use of illustrative examples throughout is helpful.

**Proposed section D.1 - Identifying the commercial or financial relations**

We note that the current transfer pricing guidelines at Chapter 1 D1.2.3 1.53 provide that 'it is… important to examine whether the conduct of the parties confirms to the terms of the contract'. We would also observe that in practice most countries’ implementation of the guidelines or their own domestic substance-over-form or similar statutory interpretation principles are likely to take into account whether intra-group contractual documentation accurately reflects the reality of the conduct between the parties. As a general comment we therefore wonder whether the significant expansion of the discussion of conduct in the proposed amendments is intended to alter, or simply clarify, the existing guidelines and practice.

Because of these existing provisions in the guidelines and domestic law, we consider that in practice in the vast majority of cases multi-national enterprises are careful in conforming their intra-group contractual relationships to the conduct in practice (and vice versa). We would therefore welcome clarification that ‘recharacterisation’ of transactions from the contractual position by tax authorities should be applied exceptionally, and only where there is clear justification for rebutting an assumption that conduct and contracts align. We are concerned that otherwise tax authorities may interpret the revised guidelines as providing justification for a broad approach of looking at conduct first and foremost and generally disregarding the contractual position. This could give rise to a great deal of uncertainty and inconsistency between tax authorities, and a need for heavy reliance on the Mutual Agreement Procedures (we have previously commented on the need for improvements here, which are only partly addressed by the current BEPS Action 14 proposals).

**Proposed section D.2 - Identifying risks in commercial or financial relations**

We welcome the focus on the identification of the allocation and management of risk as fundamental to arriving at the appropriate transfer pricing outcome. We consider that the management of risk is another example of the conduct of the parties which should be examined in accordance with section D.1 in order to determine whether the unusual step of recharacterisation by tax authorities from the contractual position is warranted.
We would welcome clarification that the consideration of risk allocation and management is indeed intended to be another dimension to the question of whether conduct conforms to the contractual arrangements.

It is not entirely clear that this is the intention, or rather whether the proposed guidelines could be interpreted as allowing recharacterisation even where the conduct of risk management matches the contractual allocation of risk, in situations where a tax authority might argue that it was not in the interests of one party for risk management to be allocated in this way.

As is acknowledged in the document, all business is built on the concept of acceptance of risk for appropriate commercial return. Many businesses are subjected to countless commercial risks over which they do not have direct control, but they target returns which will compensate the owners of the business for the risk and inherent volatility which is accepted. Business may adopt at the same time or at different times a combination of high-risk/high target return and low risk/low target return strategies. Between independent enterprises negotiating commercial terms, pricing and risk allocation are necessarily considered together. We consider that between associated enterprises there should be a presumption that risk allocation similarly should be seen first and foremost as a question to be taken into account in determining the appropriate arm's length price, assuming that conduct of risk management corresponds to the contractual position. We consider that the 'risk-return trade-off' question described in the discussion draft is necessarily linked to what is described as the issue of 'moral hazard' in that an enterprise will in third party situations accept a reduced level of control over certain risks depending on its bargaining power and as long as it is appropriately compensated for doing so.

This of course assumes that an arm's length price is capable of being determined for the relevant transaction. The discussion draft at page 14 invites comment on the application of these concepts to the example in paragraphs 90 and 91. This is somewhat confusing as the context of that example is in the discussion of the question of possible non-recognition of a transaction on the basis that third parties would not have entered into the transaction at all, rather than the question of appropriately taking into account risk allocation in determining the arm's length price.

We consider that the example at paragraphs 90 and 91 is closely analogous to the example in Chapter 9 of the existing transfer pricing guidelines at D3 9.193. On the assumption that the transaction is one which could have been entered into between third parties, we would suggest that the risk transfer inherent in such a transaction should result in a requirement that the valuation of the intangible in the example is high enough (or potentially that it may include deferred contingent consideration or an 'earn-out' or other commercially observable consideration arrangement) so as to fully compensate for the risks assumed by the transferor.

A further aspect of the allocation of risk is the financial resilience of the company assuming that risk to be able to withstand the commercial volatility which results. We consider that there is a link here with the question of capitalisation and explicit or implicit financial guarantees in a group situation.

The financial services sector

We agree that the financial services sector is a helpful area of consideration in that it often presents clear and transparent examples of how risk allocation impacts on the pricing of transactions. Often determining an arm's length price for the acceptance of risk is facilitated by transparent and liquid capital markets, eg for financial derivatives.

The sector also operates with a sophistication in linking the acceptance of risk with requirements as to the appropriate financing and capitalisation of a company, often governed by regulatory requirements.

In these respects we consider that the financial services sector should not require specific guidelines, but rather serves to illustrate and provide market evidence for the general proposition that arm's length pricing should be commensurate with the allocation and management of commercial risk.

One other observation about the financial services sector would be the existence within multi-national entity (MNE) groups of central risk management functions. These typically provide intra-group services to subsidiaries as an outsourcing of the operational aspects of risk management. The financial services sector also includes independent service providers who provide risk management services, against which intra-
group risk management service fees can be benchmarked. This evidences that aspects of risk management can itself be a service capable of being priced, which may mean that where one company has outsourced aspects of risk management to another company, comparison with arm’s length situations would imply that this should not necessarily mean that it is appropriate for the entire return in relation to the relevant assets to be transferred to the entity managing the risk.

Even outside of financial services we would note that an MNE may have central risk management functions, for example a group internal audit function, where it would be appropriate for an arm's length service fee to be determined for that service alone without disturbing profit allocation more broadly.

An example in the discussion draft at pages 22-23 is the position of a group treasury company. Despite the comments above, we do not consider that just because a group treasury function is hedging the risk borne by a subsidiary, that it could be considered as providing a service to that subsidiary. If the subsidiary is consciously taking risk, is appropriately rewarded for taking that risk, and is appropriately capitalised in order to withstand the resulting volatility, then the assumption should be that the reward to the company is appropriate. A shareholder will naturally review its entire portfolio of investments and determine, taking into account correlations and natural hedges, what its overall economic risk position is. The shareholder may then take an independent decision to hedge some of its resulting aggregate or net economic risks for its own account.

Further, the factoring example in paragraph 71 appears rather over-simplistic. See for example the wording: 'Neither party will expect to be worse off…'. An independent company with a low tolerance for risk may well factor its debts expecting that its own profits will fall, in exchange for the removal of the risk of substantial loss (or just to even out its cash flow).

**Proposed section D.4 – Non-recognition**

Whilst this proposed section is substantially new, we note that the existing transfer pricing guidelines do include provisions regarding the potential for non-recognition of transactions, including Chapter 1 D2 and Chapter 9 Part IV C. Again it would be helpful if it could be confirmed whether the proposed new section is intended to alter, or simply clarify the existing guidelines and practice.

Also we note in proposed paragraph 83 that 'the term non-recognition is intended to convey the same meaning to that understood to be conveyed by the term recharacterisation'. Clarification of this would be welcome. The connotation of the document is that 'recharacterisation' implies that a tax authority can argue that a different transaction is entered into from that purported by the contractual documentation; whereas it would appear that 'non-recognition' is intended to apply in situations where a tax authority can disregard a transaction entirely and treat it as if it had not happened at all. We do not think that these concepts are the same, and we would appreciate clarification.

The wording in paragraph 89, suggesting that an examination of all potential alternative arrangements for each party, and the use of language such as 'would not be recognised' (emphasis added), will we consider cause difficulties in practice.

We agree with the position in the current guidelines (D2 1.64) that whilst non-recognition may in some instances be warranted, 'In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation'. We would welcome confirmation that non-recognition is still viewed as exceptional and fundamentally problematic, especially given the potential need for Mutual Agreement Procedures to be invoked to ensure consistency between tax authorities and avoid double taxation.

The potential difficulties if more 'non recognition' occurs are not addressed by the short paragraph under proposed D.4.3. How is the money that has been paid out by S2, for example, to be treated (as a loan?).

**Potential special measures**

As a general observation we would note that the special measures outlined could benefit from greater detail in describing the circumstances in which they would apply, and exactly how they would operate. Another general observation would be that it would appear that the proposed revisions to the transfer
pricing guidelines discussed above are intended to deal with many of the circumstances described through their focus on risk allocation and management and conduct. If the revised transfer pricing guidelines were to succeed in these objectives, there would appear to us to be little need for special measures standing outside the overall framework of, and challenging the internal consistency and integrity of, the guidelines as revised. Introducing special measures in addition to the transfer pricing guidelines would create further areas of potential inconsistency in application between taxing jurisdictions and could be seen to provide justification for departure from the guidelines more frequently, jeopardising the international consensus of application of the guidelines.

We have the following comments on the specific options for special measures outlined:

1. **HTVI (hard to value intangibles)**
   We would suggest that the issue could be dealt with within the framework of the proposed revised guidelines.

   For example it may be the case that in a third party situation it would be difficult to agree a fixed price for a HTVI. However other third party contractual paradigms may be available and an intra-group transaction could potentially be re-characterised to fit these paradigms, eg deferred contingent consideration, or 'earn outs'. In exceptional cases, as is contemplated in the existing and proposed revised transfer pricing guidelines, it may be appropriate for non-recognition to apply to a purported intra-group transfer of a HTVI.

   We do not support a 'commensurate with income' approach or test, and we are concerned with the implication of hindsight under the potential rebuttable presumption.

2. **Independent investor and 3. Thick capitalisation**
   This appears to be a question about appropriate capitalisation within a group of companies which accept a volatile position. Again it would appear to us that focusing on a functional analysis based on conduct including risk management should be capable of addressing concerns. The presence of documented or implied intra-group guarantees should also be considered in this context.

   We would be very concerned about the potential for arbitrary and inconsistent reallocations of capital by tax authorities under option 2 and about the imposition of 'blunt instrument' ratios under option 3. Further, as in many real life cases where tax authorities challenge what taxpayers have done, there appears to be an underlying presumption that we will always be discussing attribution of profits, and not losses. Indeed, we suggest the document as a whole could be enhanced by additional commentary about the risks of loss.

4. **Minimal functional entity**
   The transfer pricing guidelines as amended should be apt to deal with concerns here through a possible recharacterisation of transactions where there are minimal functions performed in an entity in extreme cases. In other cases, it should be able to deal with through fundamental principles of arm’s length pricing of transactions where minimal functions are performed. Further, the proposed qualitative and 'quantitative' thresholds, as well as the discussion on the effect of failing the test, all seem highly subjective.

5. **Ensuring appropriate taxation of excess returns**
   We consider that transfer pricing rules should as a fundamental point of principle be capable of being operated on a consistent global basis without regard to the tax rates in any jurisdiction.
Summary
Grant Thornton International Ltd welcomes the OECD’s proposal to maintain the position of the transfer pricing guidelines as, in the context of the BEPS project, continuing to have a central role in the international tax framework for the appropriate allocation of profit and avoidance of double taxation, and hopes that the comments set out above assist the OECD in this.

If you would like to discuss any of these points in more detail then please contact Wendy Nicholls, Partner, Grant Thornton UK LLP at Wendy.Nicholls@uk.gt.com or Richard Milnes, Partner, Grant Thornton UK LLP at Richard.Milnes@uk.gt.com.

Yours sincerely

Global head - tax services
francesca.lagerberg@gti.gt.com
5 February 2015

Grove Tax Policy Institute
Mr. Vernor Soghugh
Suite 1936 - 1040 West Georgia
Vancouver BC
V6E 4H1

Mr. Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
OECD

Sent via email to: transferpricing@oecd.org

We gleefully submit comments on the Discussion Draft entitled "BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measure)" (dated 19 December 2014 ("the Draft"). If you require additional information with respect to our comments, please do not hesitate to contact us.

As a general comment, we welcome the Draft as it is engaging, fairly concise whilst dealing with a difficult topic and clarifies aspects of the existing Chapter 1 Guidelines. Specifically, the objective of the Draft to “assure that transfer pricing outcomes are in line with value creation” is a laudable goal and not one undertaken easily.

On the other hand the methodology adopted in the Draft in seeking to achieve this goal seems both flawed in theory and in the practical guidance that flows from that theory. The long discussion, along with the extensive enumeration, of the reasons for identifying economically relevant characteristics or comparability factors, beginning in Paragraph 9 and finally ending in Paragraph 15, seems wasted since it ignores the practical realities of business today. Our experience shows very clearly that the perfect comparable transaction is the elusive “Golden Goose”. In fact, the vast majority of transfer pricing reports now start, with good reason, with the disclaimer that it is impossible to identify comparable transactions.

The OECD needs simply to leave the confines and rarified air that exists at 2 Rue Andre Pascal to realize the world is now more complex. Financing, service and structuring transactions that exist today and will be invented in the future make the world of Michael Milken’s junk bonds seem like child’s play. As the world continues to evolve and the transactions undertaken by business at the forefront of that evolution continue to evolve the OECD guidelines will once again be left at best to gather dust in the corner but at
worst, and as detailed below, to steal from the pockets of the everyday working man. One wonders how many times the OECD will plug the collective holes in the wall of the dam before finally realizing that the dam itself must be redesigned if the laudable goals of the organization are to be realized and the proud history of the OECD maintained.

A more elegant solution than the one proposed in the Draft would be a fixed or flexible system of apportionment between nations. One could beat the proverbial dead horse, as the Draft seems to do, by continuing to exhort that a delineation of the transaction, a review of economically relevant characteristics/comparability factors coupled with a functional analysis, etcetera will, with a little pixie dust for good measure, lead to a perfect comparable. Poof the golden goose will appear! The flaw in this logic is that the market neither produces proper information nor will it ever especially in the case of new or unique transactions. One is left to wonder whether the proud and noble economists of the OECD now been replaced by a team of alchemists so enraptured by their pursuit of the perfect comparable/philosopher’s stone/golden goose that they cannot conceive that it doesn’t exist?

Taken to the extreme where one pretends that perfect comparables exist or could be manufactured this is nothing more than a system of apportionment. Say Company B, operating in Country B, wishes to have a sales and marketing office run by Company S, in Country S. If the perfect comparable database says the markup should be 5% this bears very little difference between the countries of B and S negotiating at arm’s length that a proper markup is 5% and publishing that ruling for all to see. So why bother with this fallacy of slicing and dicing or alchemy to produce a price?

At worst the OECD is risking making itself a puppet of the governments of the world and destabilising the economic systems that have made the lives of the people of the world better for the last several decades. To licence the prophetic warnings of Dr. Ian Malcolm to this real world context: “Don’t you see the danger in what you are doing here? Taxation is the most awesome force the planet’s ever seen, but you wield it like a child that has found his father’s rifle. You stood on the shoulders of geniuses to accomplish something as fast as you could, and before you even knew what you had, you packaged it and you are selling it. Your economists were so preoccupied with whether or not they could they haven’t stopped to think if they should.”

In particular, if you continue with this fallacy of the perfect comparable the governments of the world will adopt this, neigh will seize this, to fill their fiscal coffers at the expense of the everyday man riding the bus. The everyday business man or woman will no doubt suffer since such a system removes any incentive for the governments to act with economy and efficiency with respect to the funds taken. The judges in their court, as they have in enumerable cases in the past will say the OECD guidelines are not law but given nothing else we must rely on them. There is no check or counterbalance to this economic system in what you propose in the Draft. While distasteful to many, litigated by our forefathers and seemingly forgotten in the fray the right to arrange one’s affairs to minimize taxes serves a useful economic function. It provides a counterbalance to government and forces governments to work with efficiency in order that ever increasing taxes do not cause the source of that revenue to flee forever.

We believe very strongly in the words of Winston Churchill for we too contend “that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle.”

Furthermore, the golden goose system you propose in the Draft is bound to create significant uncertainty for taxpayers (imagine the new length of transfer pricing reports), lead to litigation and
serve to undermine economic reality. The only ones smiling in this equation will be the lawyers and accountants from the additional work you have created for them. The man riding the bus must go home later and later each day and explain to his family that he must work longer hours because the OECD says that the golden goose exists and if he only fills in enough forms, does enough ritual dances and sings the correct songs then surely one day he will find her. Eventually, the man’s wife will leave and marry the government bureaucrat who is home each day by 3pm. This is the same bureaucrat who will eventually retire with a fat pension paid for by the first man all whilst never lifting a finger to help the poor man locate the elusive golden goose.

Alternatively, the OECD could perhaps step aboard the Omnibus or the Paris Metro and realize that a better solution exists. Indeed, this better solution is already available but in far too limited practice. A solution which takes the two arm’s length parties with a vested fiscal interest in the transaction and through negotiation leads to a true comparable. Specifically, where the governments of two nations agree on an apportionment of tax (in essence an advance pricing agreement) a true comparable is created. More importantly, the economic engine of the world, and in turn the regular joe on the bus or the Paris Metro, is not damaged by the over-reaching arm of government. Instead, each nation in the negotiation has a vested interest in securing the business of that enterprise and the resultant tax revenues which flow from it. However, and this is most important, each nation is constrained in the knowledge that if they are too greedy perhaps when the man riding the bus decides within which countries to structure his affairs he will go elsewhere if they ask too much. So the governments cannot be too greedy and must be efficient in using the funds they do earn. This is the essence of competition. The same competition in the business world that led to the fall of the Berlin Wall, the death of communism and prosperity like man has never seen before. Is it perhaps time that governments compete with others and this prosperity becomes multiplied for all mankind?

The purpose of our comments are not to extol the virtues of such a system but rather to highlight a significant flaw in the Draft. Therefore, we would suggest that the OECD abandon, or at a minimum reflect carefully on, the search for the perfect comparable where none exists (i.e. the proverbial golden goose). Instead, in its place the OECD could throw its full weight behind a system of apportionment with a requisite negotiation framework for each country. We would further suggest that such a system be open and public with rulings on apportionment being published and freely available to promote transparency. In the words of the US Supreme Court Justice Brandeis “Sunlight is the best disinfectant”

In summary, the OECD is on the cusp of greatness and a moment that will be judged in history much the same way the Marshall Plan and its implementation fill the history books of youngsters today. Just as Ronald Reagan challenged Mikhail Gorbachev to destroy the Berlin Wall we challenge you to rethink your approach in the Draft. If the OECD is serious about assuring that the transfer pricing outcomes are in line with value creation the OECD can prove it by getting rid of this hunt for the golden goose and bring in a system where arm’s length parties (governments) actually negotiate a fair and equitable price.

We are interested in attending the public consultation on the discussion draft on 19-20 March 2015 in Paris, France to speak further on these matters.

With kind regards,
Mr. Vernor Soghu
Director
February 3, 2015

Attn:
Mr Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax and Policy Administration
OECD
Paris
Email: TransferPricing@oecd.org

Re: BEPS Actions 8, 9 And 10: Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (Including Risk Recharacterisation, And Special Measures), 19 December 2014 – 6 February 2015

We respectfully present our comments on the above Discussion Draft.

We are an accountancy firm keen to see reasonable tax paid without harming bona fide international business operations.

Background:

The OECD action plan, published in July 2013, identifies 15 actions to address BEPS, and sets deadlines to implement these actions.

Actions 8, 9, and 10 of the BEPS Action Plan relate to a number of closely related topics. These include the development of rules to prevent abuse caused by:

- Transferring risks or "excessive capital" to offshore companies and using this to allocate "inappropriate" profit to them.
- Engaging in transactions which would not, or would only very rarely, occur between third parties.
- Transfers offshore of hard-to-value intangibles.”
Instead, the main aim of the OECD Discussion Draft is to assure that transfer pricing outcomes are in line with value creation.

The draft has two parts. Part 1 deals with risk assessment. Part 2 proposes special (controversial) measures.

Risk Assessment:

Tax planning techniques within multinational groups might include allocating profit to offshore companies that own intangible assets and/or bear substantial business risks.

This is because in business, there is often a risk-return trade-off.

Part 1 of the Discussion Draft then takes aim at the above techniques. If the asset owner does not have the ability to control risks associated with the exploitation of the asset, the legal owner of the asset is in substance only providing financing equating to the cost of the asset and should be remunerated on that basis (Para.63).

In circumstances where the party providing risk management is not in the supply chain...a fee is likely to be required reflecting the value of risk management. (Para.77).

A party which does not control risk...will not be entitled to unanticipated risks (Para.78).

Arrangements should be subject to non-recognition (recharacterization) would not afford each of the parties an opportunity to enhance or protect their commercial or financial positions on a risk-adjusted basis (Paras. 83-89).

Value Generation:

Part 1 of the Discussion Draft also states: "... it is important to understand how value is generated by the group as a whole ...and the contribution that the parties make to value creation...While one party may provide a large number of functions, it is the economic significance of those functions in terms of their frequency, nature and value...that is important" (Para.16).
Potential Special Measures:

Part 2 of the Discussion Draft proposes special (controversial) measures. There are five "options".

Option 1 deals with "hard-to-value intangibles" (HTVI). The OECD proposes to permit a tax administration to adjust their price based on the actual outcome, imputing a contingent payment mechanism. This use of hindsight by a tax administration may only be rebuttable if the taxpayer can demonstrate "the robustness of its ex ante projections".

Option 2 deals with inappropriate returns for providing capital in a capital-rich asset-owning company (presumably offshore) that depends on another company to generate a return from the asset. The OECD says capital (i.e. assets) should be reallocated to the other company (presumably onshore) as that would be a more rational investment opportunity for an independent investor.

Option 3 deals with "thick capitalization". A capital adequacy ratio would be determined and excess capital would be deemed to generate interest income for the provider (presumably onshore) of the excess capital.

Option 4 deals with a so-called minimal functional entity. If a company lacks qualitative attributes (unable to create value) or quantitative attributes (performs mainly routine functions), its profits would be re-allocated to other more functional entities in the group.

Option 5 deals with ensuring appropriate taxation of excess returns. This would involve standardizing existing rules in most western countries regarding controlled foreign corporations (CFCs) that pay tax below an unspecified tax rate over the last three years, less a foreign tax credit.
Comments:

- **Part 1 - Risks - Message Lost**
  The text of Part 1 (dealing with risks) is long and can apparently be summarized in one sentence:
  
  Profit should be allocated to countries where people, such as engineers, generate value rather than offshore companies that lack the people to manage assets and risks.

  **Recommendation:** Could the OECD please confirm this is its message.

- **Part 2 - Potential Special Measures – Too Brief**
  By contrast Part 2 (potential special measures) is brief, unclear in many places and full of jargon. The proposed measures are not fully evaluated. Instead, respondents (like us) are invited to do so by reference to a list of criteria. The chief criterion is value creation.

  **Recommendation:** Please clarify Part 2 including the jargon. Please see our alternative recommendations below.

- **Option 1 – Reliance On Hindsight**
  The proposals in Option 1 for valuing hard—to-value intangibles require immense powers of prophesy, failing which the tax administration can apply hindsight to tax a different amount. This means MNCs must become hardened gamblers. And if taxpayers overvalue their intangibles, will they later receive a tax refund?

  **Recommendation:** We recommend the OECD allow normal professional valuation techniques to be used without fear of hindsight adjustment later on. The net present value technique should be allowed as a safe harbor.

- **Option 2 – Capital Rich Companies – Too Vague**
  The proposals in Option 2 (capital rich companies) are very vague and brief. Each onshore country in which an MNC operates seems likely to allocate capital and assets to their taxing jurisdiction, resulting in multiple taxation.
Recommendation: Drop Option 2, it seems unworkable. Please see our alternative recommendations below.

- **Option 3 - Thick Capitalization**
  Option 3 (thick capitalization, taxing deemed interest) looks likely to be ineffective so long as interest rates remain low. Moreover, if good use is made of capital, such as investment in research and development into life-saving drugs, why should such good use be penalized by taxation? R&D costs money which is usually funded by capital not loan finance.

  Recommendation: Drop Option 3, it seems unworkable and unreasonable in a low-interest research-driven age. Please see our alternative recommendations below.

- **Options 4 & 5 - Minimal Functional Entities & Excess Returns**
  Options 4 and 5 (minimal functional entities, taxing excess returns) seem to add little to existing legislation in most western countries dealing with (a) transfer pricing, (b) central management and control, and (c) controlled foreign corporations.

  Recommendation: If the intention is to standardize such rules across the OECD, say so. But the impact seems likely to be small. Please see our alternative recommendations below.

- **Part 2 – Our Alternative Recommendations**

  All in all, the proposals in Part 2 seem likely to result in multiple taxation and uncertainty. And challenging the deployment of capital would be wrong in the post-communism era. Alternative proposals are called for.

  Recent published tax concerns relate primarily to intangible assets/intellectual property (IP). IP includes technology (knowhow), brands, trade names, and so forth – in virtually all sectors from high tech and life sciences to traditional industries.
We recommend the OECD first identify the taxation issues associated with IP.

In our opinion, these issues include:

1. Does the IP genuinely exist? Is there a legitimate asset?
2. How developed is the IP?
3. If the IP is transferred (e.g. offshore), what is its value for tax purposes, having regard to its stage of development?

We briefly discuss these issues below.

1. Is there a legitimate asset?

   The OECD should clarify criteria for recognizing the existence and legitimacy of IP. Enforcement is needed against phony or non-existent IP. In the modern global village, bona fide assets should not be penalized by taxation regardless of their location.

   Regard should be had to patents, brand names, engineers, size of the global market, technical requirements, languages and cultures, and so forth.

2. How developed is the IP?

   Many high tech companies and projects fail when R&D fails to generate hoped-for technological products. Likewise, many pharmaceutical projects do not result in useful new drugs, and if they do, exhaustive clinical trials is needed lasting many years. Many movies fail at the box office. Catchy trade names and interesting designs often do not catch on after all.

   There is much risk, and this is typically managed by raising capital (not loans) to finance the R&D. When the money runs out, it is necessary to assess whether to invest more capital or stop and lay off the R&D personnel.

   In practice, the R&D successes are fewer than the failures, but usually only the successes enjoy publicity.
Also, the stages of development of IP are as many and varied as the colors of the rainbow. The possibilities range from theoretical to proven to prototype to successful to obsolete in need of next-generation research (and many more).

And if a competitor emerges with a better product or a new disruptive technology, the IP can lose great value rapidly.

3. **If the IP is transferred (e.g. offshore), what is its value for tax purposes, having regard to its stage of development?**

Needless to say, the stage of development and the state of competition need to be factored into the IP value for tax purposes.

There are many valuation techniques and it would not be appropriate to prescribe in advance which technique(s) should be applied.

Nevertheless, as a safe harbor, we recommend that if IP is transferred within a group, net present value (discounted cash flow) techniques applied in a bona fide manner should be allowed and respected by tax authorities as being arm's length, even if the unexpected subsequently occurs.

Furthermore, when assessing payments for the use of IP, net present value (discounted cash flow) techniques applied in a bona fide manner should again be treated as an arm's length safe harbor.

* * * * * *

We will be happy to answer any questions arising.

Yours Truly

Leon Harris, CPA (Israel), FCA(UK)

Harris Consulting & Tax Ltd
February 6, 2015

Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
France

Submitted by email: TransferPricing@oecd.org

Ref: BEPS Actions 8, 9 and 10, Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures)

Dear Andrew,

The OECD submitted for comment a document titled "Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)" (hereafter “BEPS Draft”). We welcome the opportunity to comment on that draft.¹

According to the BEPS Action Plan:²

BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from jurisdictions where the activities creating those profits take place.

We have reviewed the changes proposed to Chapter 1 of the OECD Guidelines that are intended to address this concern. We discuss below whether it is necessary to consider issues relating to “moral hazard” when establishing an

¹ The authors are Managing Directors in the economic consulting firm Horst Frisch Incorporated, and provide expert advice to private and public sector international clients facing complex transfer pricing and other economic issues. The views expressed are those of the authors and do not reflect the views of other Managing Directors of Horst Frisch or its clients.
arm’s length price. While we are sympathetic to the OECD’s concern for issues of double non-taxation, we conclude that the goals of the BEPS Action Plan can be achieved without the need to consider issues of “moral hazard.” Further, if a transfer price has been properly determined under the "arm's length standard" (ALS), the form of the transaction need not be adjusted.

Our specific conclusions are as follows:

- Attempting to “correct” a controlled transaction for imputed moral hazard risks is both unnecessary and could lead to non-arm's length results.
- Methods for establishing arm’s length prices that focus on the price of a transaction, not the structure of the transaction, are already in place and have been widely supported.
- Re-characterizing a controlled transaction to reflect a theoretically more “commercially rational” arrangement would be unworkable, given the number of potential alternatives and the need to choose among them.
- The goals of the BEPS Action Plan can be achieved by focusing on the correct determination of an arm’s length price even in situations that involve the sale of intangibles.

I. Adjusting for "Moral Hazard" Is Not Necessary

The BEPS Draft defines the issue of moral hazard as “the lack of incentive to guard against risk where one is protected from its consequences” and suggests that “unrelated parties would seek to avoid moral hazard that may arise in situations where one party assumes a risk without the ability to manage the behavior of the party creating its risk exposure.” The BEPS Draft further suggests that the concept of moral hazard may be used to support the proposition that “it generally makes sense for parties to be allocated a greater share of those risks over which they have control.”

However, the BEPS Draft also goes on to note that “the existence of common control” means that moral hazard is generally not present in related party transactions. We concur with this point on common control; the fact that parties have the same, mutual interests is, after all, what gives rise to the need for an arm's length standard to set controlled prices in the first place.

Further, a transfer pricing adjustment that relies on moral hazard for the purpose of allocating risk could, in fact, violate the arm's length principle. There are many uncontrolled situations in which one party reaps profits (or losses) from taking risks over which it has no direct control. An investor in a stock, for instance, is entitled to a proportionate share of profit or loss because capital has been put at

---

5 BEPS Draft, page 14.
risk, not because he has direct control over either the company or the performance of the stock. While one may question the choice to buy or hold a stock, the investor is nonetheless entitled to expect a return on that investment.

In sum, the interests of related parties are aligned with the general goal of maximizing multinational enterprise group profits. Consequently, direct control of risk is not a relevant factor in the determination of an arm's length outcome. We do not believe, therefore, that "imputed moral hazard" has a role in determining the allocation of risks between associated enterprises.

II. The OECD Already Endorses Use of Pricing Methods That Do Not Require "Comparable" Arm's Length Contractual Arrangements in order to Estimate Arm's Length Prices

Application of the ALS is achieved by considering the question "if an uncontrolled party had entered into a similar transaction, what would its price have been?" This approach acknowledges that controlled parties are able to enter into transactions that may not be available to uncontrolled parties; in other words, controlled parties are typically different from uncontrolled parties. Nonetheless, the goal of achieving tax parity through intercompany prices requires a solution even if reliable comparable transactions are unavailable.

The transfer pricing community has long debated the question of how to set prices when no "comparable" transaction exists. In recent years, the OECD members agreed upon a solution in the form of profit-based methods like the transactional net margin method (TNMM). Profits are measured on the basis of comparisons to the rates of return (or other net profit indicators) of similar, not necessarily identical, uncontrolled parties (i.e., the functions and risks of those uncontrolled parties may vary). In accepting the TNMM, OECD members have recognized that certain functional or risk differences either do not matter, or can be mitigated by an adjustment to the controlled price.

The endorsement of profit-based methods indicates that the OECD members have agreed that prices can be determined in the absence of closely comparable arm's length transactions. Use of a TNMM, for instance, does not require changing the form of a taxpayer's transaction, or disregarding it altogether.

III. Expanded Re-characterization of Transactions Is Unworkable

Under the current BEPS Draft, the OECD appears to be taking application of the ALS in a very different direction than its historical precedent. The current OECD Guidelines are clear that, in other than exceptional circumstances, tax authorities
should not disregard the actual transaction undertaken, nor substitute a hypothetical transaction for the actual transaction.\textsuperscript{6}

A standard based on "moral hazard" effectively poses the question "if an uncontrolled party had entered into a transaction, what would its structure have been?" Following this, controlled prices would be estimated based on that structure, or, in the absence of any "comparable" arm's length arrangement, not estimated at all. In our view, this represents a radical change in the application of the ALS.

Permitting non-recognition of transactions for which uncontrolled comparables cannot be found would substitute the judgment of the taxing authority for the business judgment of the corporation. Since different choices are made by different arm's length companies even when faced with the same set of facts, it is difficult to see how one would be able to choose in a "commercially rational" fashion. Giving revenue authorities the option to disregard transactions could penalize companies seeking to organize their affairs in ways that are both beneficial to shareholders and consistent with the arm's length standard.\textsuperscript{7}

IV. Goals of the BEPS Action Plan Can Be Achieved by Focusing on Setting Arm's Length Prices, Not Structures

The BEPS Action Plan for Actions 8, 9, and 10 states that one goal is to "[a]ssure that transfer pricing outcomes are in line with value creation."\textsuperscript{8} In our opinion, the BEPS Action Plan and current BEPS Draft fail to focus sufficiently on the centrality of investment in generating and, subsequently, measuring arm's length returns. While there is a detailed discussion of risk and functions, considerably less emphasis is placed on investment.

The proper recognition of and reward for investment is central to the intercompany transfer of intangibles in particular. Thus, in our view, the situation discussed in paragraphs 90-92 can be regarded as primarily a pricing challenge. There are valid business reasons why a company may want to hold trademark ownership in a particular entity (e.g., legal protection). These are reasons which a taxing authority cannot reasonably be expected to judge. The taxing authority can, however, use the tools currently at its disposal to determine the value of that trademark on the date of sale.

\textsuperscript{6} Specifically, paragraphs 1.64 through 1.69 of the OECD Guidelines address when it is and is not appropriate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction.

\textsuperscript{7} In addition, disputes could arise between tax authorities that have different opinions of what is commercially rational.

\textsuperscript{8} BEPS Action Plan, page 20.
The challenge facing the OECD is how to effectively reconcile a corporation’s right to organize as it sees fit with the valid concern that exercising such rights could lead to non-arm’s length results. The answer, we believe, is that non-arm’s length income-shifting is best addressed through more accurate determinations of arm’s length prices. In most cases, an arm’s length outcome can be achieved by using the pricing tools in the current OECD Guidelines, including profit-based methods, while still respecting both corporate form and separate legal entity accounting.

Sincerely,

Barbara Rollinson  R. William Morgan  Lesley Cameron
Dear Mr. Hickman,

We hereby provide you with comments on the “discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures)”. Our main comments concern the issue of non-recognition.

1. The guidance in section D.4. of the discussion draft concerns non-recognition of a transaction. Is it also possible to disregard ‘merely’ one or more terms other than the price, i.e. structural terms of a transaction? Consistent with the guidance in par. 1.64 and par. 1.65 of the Guidelines 2010 we recommend an affirmative answer.

2. The guidance in par. 82, 89 and 92 in section D.4. of the discussion draft indicates that a transaction that lacks the fundamental economic attributes of arrangements between unrelated parties must be disregarded. Does a tax administration have a discretionary competence or is it obliged to disregard a transaction that lacks the fundamental economic attributes of arrangements between unrelated parties?

3. Is non-recognition of a transaction required/possible (see comment 2), solely because it does not exhibit the fundamental economic attributes of arrangements between unrelated parties (‘an objective test’). Or should the associated enterprise actually be aware of the fact that the transaction does not exhibit the fundamental economic attributes of arrangements between unrelated parties (‘a subjective test’)? Or is it necessary that the associated enterprise reasonably should have been aware of the fact that the transaction does not exhibit the fundamental economic attributes of arrangements between unrelated parties (‘an objectified subjectivity test’)?

4. Conceptually, non-recognition of a transaction or non-recognition of (contractual) structural terms is possible for two qualitatively different reasons:
   1. The factual behavior of the parties does not conform to the terms of the contract;
   2. The transaction or the (contractual) structural terms would not have been agreed between independent enterprises.

In the discussion draft no (explicit) distinction is made between these two reasons for non-recognition. Disregarding the transaction or disregarding (contractual) structural terms for the first reason could be described as factual non-recognition. Strictly speaking, this option does not come within the purview of the arm’s length principle, since no comparison is made with independent enterprises. Disregarding the transaction or disregarding (contractual) structural terms for the second reason could be described as arm’s length non-recognition.¹ We suggest to add the distinction between these two qualitatively different reasons for non-recognition and to use the aforementioned terminology in referring to these reasons for non-recognition.

5. We request that consideration is given in section D.4. of the discussion draft to the fact that associated enterprises may conduct transactions and may agree on contractual (structural) terms that do not maximize the integrated (combined) pre-tax profit, since managers are boundedly rational

¹ The terminology factual non-recognition and arm’s length non-recognition is not used by the OECD. It is inspired by the distinction of the ‘factual substance prong’ and the ‘arm’s length prong’ of ‘economic substance’ in A. Bullen, Arm’s Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing, Online Books IBFD 2011.
instead of *fully rational*. In short, managers may not be fully informed about all available options and they have limited cognitive capacities for processing the information that is available to them. Non-profit maximizing transactions and non-profit maximizing contractual (structural) terms that are due to *bounded rationality* are not due to the relatedness between the associated enterprises and *arm’s-length non-recognition* is therefore not appropriate.

6. With respect to *arm’s length non-recognition* we recommend that either:

1. The guidance in the Guidelines 2010 is maintained and clarified, namely that transactions or (contractual) structural terms may be disregarded if and only if for at least one of the associated enterprises a realistically available option that is clearly more attractive exists; or

2. In the Guidelines the guidance in the discussion draft is adopted that a transaction must be disregarded if and only if it lacks the fundamental economic attributes of arrangements between unrelated parties. In this case we suggest to add that (contractual) structural terms must or may (see comment 2) be disregarded (see comment 1) as well. Additionally, we suggest to add that a transaction or (contractual) structural terms lack the fundamental economic attributes of arrangements between unrelated parties if for at least one of the associated enterprises a realistically available option that is clearly more attractive exists.

Irrespective of the option chosen, we suggest to add that a realistically available option is clearly more attractive if its expected long-term profit is clearly higher than the expected long-term profit of the transaction or the (contractual) structural terms. Furthermore, we suggest to add that *arm’s length non-recognition* is only allowed if the associated enterprise reasonably should have been aware of a realistically available option that is clearly more attractive (‘an objectified subjectivity test’).

7. The guidance in the discussion draft is not entirely clear on the relationship between the *control over a risk* and the *financial capacity to bear a risk*. Is the *financial capacity to bear a risk* a relevant but not determinative factor in determining whether the allocation of risks in a controlled transaction is *arm’s length*, as seems to be suggested in par. 66 (first sentence) of the discussion draft? Or is the *control over a risk* the single relevant factor, as seems to be suggested in par. 78 (last sentence)?

We hope that these comments will be of use for you.

Yours sincerely,

Prof. Dr. I.J.J. Burgers  
Professor of International Tax Law, Faculty of Law and Professor of Economics of Taxation,  
Faculty of Business and Economics, University of Groningen, the Netherlands

A.J. van Herwaarden, LLM  
PhD candidate, Faculty of Law, University of Groningen, the Netherlands

---

2 There are problems with both a subjective and an objective test. Under a subjective test, an enterprise may claim not to have been aware of a realistically available option that is clearly more attractive, even though in fact, it was aware of such an option. Furthermore, an enterprise may truly not have been aware of a realistically available option that is clearly more attractive, because it had intentionally investigated no or very few alternatives to the transaction actually undertaken. In an objective test, non-profit maximizing transactions and non-profit maximizing contractual (structural) terms that are not due to the relatedness between the associated enterprises may – contrary to the aims of the arm’s length principle - be disregarded (see comment 5). An objectified subjectivity test does not suffer from the problems of the subjective test. The problem of the objective test is mitigated in the objectified subjectivity test by the notion that a realistically available option must be *clearly* more attractive and its expected long-term profit must be *clearly* higher. *Arm’s length non-recognition* is not allowed if managers, for example due to *bounded rationality*, do not notice a realistically available option that is *slightly* more attractive.
VIA E-MAIL

Mr. Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
Organisation for Economic Co-operation and Development  
2, rue André-Pascal  
75116 Paris  
France  
TransferPricing@oecd.org

Re: Comments on the 19 December 2014 Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures)

Dear Mr. Hickman:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, mining, telecommunications, oilfield services, transportation, computer technology, energy, pharmaceuticals, entertainment, software, IT systems, publishing, and electronics.1 The group’s purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

The Alliance appreciates the opportunity to provide input to the OECD with respect to the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures) released by the OECD on 19 December 2014 in the context of BEPS Actions 8, 9, and 10. Our comments are set forth in the Annex to this letter.

1 The current membership of the IAPT is made up of the following companies: Adobe Systems, Inc.; Anheuser-Busch InBev NV/SA; A.P. Møller-Mærsk A/S; AstraZeneca plc; Baker Hughes, Inc.; Barrick Gold Corporation; BP plc; Chevron Corporation; Cisco Systems, Inc.; Exxon Mobil Corporation; Hewlett-Packard Company; Johnson Controls, Inc.; Microsoft Corporation; Procter & Gamble Co.; Reed Elsevier plc; Repsol S.A.; Sony Corporation; Texas Instruments, Inc.; Thomson Reuters Corporation; Tupperware Brands Corporation; and Vodafone Group plc.
We look forward to the opportunity to participate in the consultation to be held on 19-20 March 2015 with respect to this topic and would appreciate an opportunity to speak at the consultation. We also stand ready to respond to any questions or to provide further input as the work of the OECD on this item continues.

Sincerely yours on behalf of the Alliance,

Caroline Silberztein  
Baker & McKenzie SCP  
Counsel to the Alliance

Annex
ANNEX

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON THE 19 DECEMBER 2014 DISCUSSION DRAFT ON REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERISATION AND SPECIAL MEASURES)

6 FEBRUARY 2015
1. Executive Summary

1. We are pleased to provide hereafter our comments on the 19 December 2014 Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (hereafter “TPG”) (Including Risk, Recharacterisation and Special Measures) (hereafter “the Draft”).

2. The Draft is an extremely important document and represents an ambitious attempt to deal with some of the more complex aspects of the arm’s length principle. We hope our comments will help the OECD refine the analysis. In drafting these comments, we kept in mind the objectives of Actions 8-10 as well as the need to preserve a principled conceptual framework.

1.1 The Draft dramatically expands the scope of non-recognition

3. Our members express concern about the ease with which tax administration may disregard contractual terms if the proposed guidance in the Draft was confirmed. We strongly believe that disregarding taxpayers’ transactions should remain exceptional and restricted to appropriately narrowly targeted situations. Doing otherwise would impede contractual freedom, agility of business organisations, and create significant uncertainty and double taxation potential because of the replacement of principled guidance with the subjective judgment of tax authorities second-guessing business decisions.

4. We note that the Draft introduces a new concept, which is the need to “accurately delineate” the taxpayer’s controlled transaction. We find that this new concept is not needed and in fact introduces confusion in the guidance. In our view, what is needed is to gain an understanding of the controlled transaction,\(^2\) including through a detailed functional analysis. We are concerned that the introduction of this new phrase may make non-recognition considerations a standard part of the initial review of a taxpayer’s transaction, as this would create significant uncertainty and instability in business arrangements, as confirmed by the language in Sections D.2.5-D.2.6 of the Draft on risk allocations and in Section D.4 on non-recognition.

1.1.1 With respect to risk allocation

5. We find that the Draft (in particular Sections D.2.5-D.2.6) expands the scope of situations where a tax administration would disregard the transaction of the taxpayer and substitute for it an alternative transaction with a differing risk allocation based on the location of control functions. This goes well beyond the arm’s length principle if not grounded in a comparison with market behaviours, and it has the potential of creating major uncertainties. Non-recognition is a serious undertaking which should be restricted to appropriately targeted situations and remain exceptional.

6. We are especially concerned with the extent of the guidance allowing tax administrations to disregard contractual terms which is introduced in Section D.2, i.e. outside Section D.4 which is the

\(^2\) See Step 3 of the typical process proposed at TPG 3.4.
section dealing specifically with the non-recognition of transactions. An analysis of arm’s length risk allocations should not be the back door to disregarding contractual terms in other than exceptional cases. Risk reallocations which involve disregarding contractual terms should be subject to specific and well targeted guidance on non-recognition of transactions in exceptional circumstances and should not be presented as a genuine part of the comparability analysis in general.

7. We would support stronger references in the Draft to the analytical framework which was developed by the OECD in chapter 9, Part I (especially 9.11-9.33).

8. The absence of any role for comparables in the proposed new guidance on risks is troublesome. If the guidance is intended to be within the arm’s length principle, then a solid principled reference to what independent parties would have agreed is needed. Within the arm’s length principle, tax administrations cannot disregard a contractual risk allocation if there is evidence that similar risk allocations exist between independent parties transacting at arm’s length in comparable circumstances. This was acknowledged in Chapter 9 (see 9.18). We urge the OECD to revise the proposed new guidance to acknowledge the role of comparables, where they exist, in any transfer pricing analysis.

9. Based on the proposed new guidance, risk management would become the one most critical criterion for allocating risk. We note that this would differ from the existing guidance in Chapter IX of the TPG where control is a relevant although non-determinative factor. We find that such heavy reliance on control functions has a strong Article 7 flavour, and does not take into account the existence of separate legal entities in an Article 9 context. We believe that it would create too much uncertainty, and that tax administrations should not dictate to MNEs how to organize their business. Rather, tax administrations should endeavour to assess the pricing of the taxpayer’s transactions to the largest and thoroughest extent possible, unless such contractual terms do not reflect the reality of the arrangements between the parties. Furthermore, we think that the concept of “moral hazard” which underpins much of the new proposed guidance is not a solid theoretical foundation to reallocate risks each time the risk-bearer does not perform the entirety of the management function.

1.1.2 In general cases

10. Section D.4 of the Draft poses a new, broader standard for non-recognition. Again, we insist that it is essential to reaffirm that non-recognition should be limited to exceptional cases only. We are very concerned that TPG 1.64 was deleted from the proposed new guidance, as this paragraph makes some very fundamental points and deleting it would send the wrong signal to the business community and tax authorities.

11. We are also concerned that there is very little guidance on the consequences of non-recognition (only 2 sentences at paragraph 93). Broadening the situations for non-recognition without providing any clear guidance as to the consequences of non-recognition would lead to unprecedented uncertainty and a dramatic increase in unresolved disputes.

1.2 Lack of clear policy direction on synergies and integration benefits

12. We are concerned with the apparent lack of clear policy direction in relation to synergies and integration benefits in the various OECD papers (existing and draft guidance). For instance, diverging pieces of guidance are proposed by the OECD to deal with central procurement:
• Paragraphs 9.154-9.160 indicate that the five OECD recognized transfer pricing methods may potentially be applicable to a central purchasing function and the selection of the most appropriate will depend on the functional analysis of the parties and the roles played by each in the creation of synergies, cost savings, or other integration effects.

• Examples 1 to 5 of the September 2014 Guidance on Transfer Pricing Aspects of Intangibles seems to suggest that cost savings should largely be allocated to affiliates. Example 3 suggests that the central purchasing function would earn a simple cost plus.

• Paragraph 77 of this Draft in relation to the oil distribution example at paragraph 51 suggests that “the parent’s contribution could be considered to have two parts: its ability to secure credit could be interpreted as reflecting the strength of its balance sheet as well as the expertise of the senior management. As a result a fee could be computed in two parts; one by reference to a guarantee fee, another by reference to high value consultancy services.”

• The discussion draft on Profit Splits contains a series of examples which suggest the appropriateness of the profit split method in cases where one-sided methods can be reliably applied, because of the presence of “integration” or coordination.

13. Paragraph 1.10 of the TPG notes that “There are […] no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises.” The guidance in the TPG was developed based on the arm’s length principle, treating members of MNE groups as if they were independent parties and ignoring passive association benefits (see paragraph 7.13 of the TPG). The recent documents drafted in the context of the BEPS Action Plan, including Section D.8 of the proposed revised Chapter I and the discussion draft on profit splits, aim at providing more guidance on synergies and integration. In our view, they still lack a clear direction and coherence on these questions. This poses a critical difficulty to MNE groups which currently face situations where:

• the tax administrations of countries of affiliates
  o restrict the deductibility of intragroup service fees (a position which may be supported by some aspects of the draft on low value-adding services, which regard certain intragroup service charges as largely consisting in base-eroding payments) and
  o increasingly claim that integration benefits should be reallocated locally, e.g. through profit splits (a position which may be supported by some aspects of the Guidance on the Transfer Pricing Aspects of Intangibles), and
  o do not accept loss-making situations, even in situations involving full-fledged local affiliates,

• while at the same time the tax administrations of countries of parent companies
  o require such intragroup activities to be charged, at least at cost or cost plus,
  o and may even require more than cost or cost plus (for instance, a guarantee fee plus high value added service compensation in the above example as per paragraph 77 of the Draft).
We respectfully submit that the OECD should be extremely careful not to entertain diverging views in its drafts on such fundamental issues, as the potential for disputes and double taxation is huge. We believe that the facts and circumstances framework of paragraphs 9.154-9.160 of the TPG is reasonable. In any case, we urge the OECD to clarify what the preferred solution is, to improve the consistency among its various drafts, and to reach consensus.

1.3 Complexity and compliance burden

We believe that the Draft presents a risk of over complex guidance, as well as compliance and enforcement burdens for simple cases. In our view, the complex, sophisticated analysis described in the Draft should only be relevant for significant risks (e.g. significant entrepreneurial risks only). The Draft often requires very detailed and full analysis of risks and risk management. We believe this is not a realistic documentation standard as far as comparables are concerned, as such information is not available in the public domain.

Similarly, we think that the OECD should confirm that the proposed new guidance does not require all the options realistically available to be documented as this would set an unrealistic and unnecessarily burdensome compliance standard.3

1.4 Need for consensus

We think it is essential for the OECD to achieve consensus on the final guidance in order not to increase risks of double taxation, uncertainty, and compliance burden which would result from differing standards.

1.5 No retroactive application

The proposed guidance would consist in a substantial change in the existing TPG, in particular in relation to the proposed new prominent role of risk management and the proposed new criterion for non-recognition of taxpayers’ transactions. Therefore, such guidance if adopted should not apply retroactively and would raise important questions in relation to its articulation with Article 9 of the Model Tax Convention, existing bilateral treaties, and domestic laws.

1.6 Compliance with the arm’s length principle

Any guidance which would not be grounded in an analysis of market behaviours and comparables, where available, would diverge from the arm’s length principle and raise important questions of compliance with Article 9 of the Model Tax Convention and existing bilateral treaties, as well as of its articulation with domestic laws. Issues would arise both in relation to implementation of the new guidance and interpretation by courts.

2. Comments on Part I: Risks

2.1 Risk preferences

The OECD poses the question of “the extent to which associated enterprises can be assumed to have different risk preferences while they are also in fact acting collaboratively in a common undertaking.” As noted in the Draft, this question touches upon the very heart of the arm’s length principle.

---

3 TPG 9.64.
principle. The arm’s length principle is grounded in the notion that the price of controlled transactions should not be artificially manipulated, i.e. should not be set at a higher or lower level than what independent parties would have agreed upon, taking advantage of the existence of a control relationship between the parties. In other words, it attempts to ignore the influence of the control relationship and tests a controlled transaction by reference to uncontrolled transactions. It follows that the collaborative nature of the group will generally be ignored, unless it translates into concerted group actions. This in our view is consistent with the guidance on incidental benefits at paragraph 7.13 of the current TPG and paragraphs 7.13-7.14 of the 3 November 2014 Discussion Draft containing proposed modifications to Chapter VII of the TPG on low value-adding services.

21. Synergies and other group effects are inherent to the functioning of MNEs. Their effects can be positive or negative, and they are extremely difficult if not impossible to exhaustively identify and quantify. The OECD should be cautious not to make the arm’s length principle inapplicable to MNE groups by requiring detailed consideration and compensation of implicit group effects.

2.2 Moral hazard

22. Moral hazard issues arise in situations where the risk is borne by one party while another party has the ability to take actions which influence the occurrence and/or magnitude of the risk and the risk-bearing entity does not exert control over the risk-controlling entity. In such situations, there is a risk that the other party may act contrary to the interests of the party bearing the financial consequences of the risk.

23. Between independent parties, it is possible to mitigate the moral hazard issue if the risk-bearing party exerts control over the one which has the ability to influence the occurrence or magnitude of the risk. This notion supports the existing guidance at paragraph 9.24:

While it is not necessary to perform the day-to-day monitoring and administration functions in order to control a risk (as it is possible to outsource these functions), in order to control a risk one has to be able to assess the outcome of the day-to-day monitoring and administration functions by the service provider (the level of control needed and the type of performance assessment would depend on the nature of the risk).

Q1. Under the arm’s length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?

24. In situations where the risk-controlling entity is distinct from the risk-bearing entity, the question arises whether their interests are aligned.

- If the interests of the risk-controlling and risk-bearing entities are not conflicting, then there is no need to take moral hazard into account. This may be the case in particular if the risk-controlling entity does not have any incentive to act contrary to the interest of the risk-bearing entity.

- If the risk-controlling entity has another option realistically available that is clearly more favourable to it than proceeding in accordance with the interest of the risk-bearing entity, then:
The risk-bearing entity may exercise control over the risk-controlling entity to ensure that the latter does not act contrary to the interest of the former. This is in line with paragraphs 9.24 of the TPG and 69 of the Draft. Note that in such a case, the risk-bearing entity becomes the actual risk-controlling entity; and/or

The risk-bearing entity may incentivise the risk-controlling entity to ensure that the latter is not worse off acting in the interest of the former than it would be otherwise. In this case, the interests of both entities become aligned and there is no longer a moral hazard issue.

25. Accordingly, we do not see the notion of “moral hazard” as providing a solid foundation to justify reallocating risks among associated enterprises just because the risk-bearing entity does not perform the risk management function. We believe that moral hazard is not a systematic issue, including when the risk-bearer and the risk-controlling entity are different parties. Furthermore, we believe that where moral hazard arises, it generally can be addressed through a pricing adjustment, and only exceptionally warrants ignoring the contractual terms.

Q2. How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?

26. The Draft states at paragraph 67 that: “At arm’s length companies may be unwilling to share insights about their core competencies with third parties for fear of losing intellectual property or market opportunities. Third parties may be unlikely to provide insurance for core competencies unless they have significant information about and control of potential outcomes due to moral hazard that the incentive to manage risk by the insured party is lowered.”

27. In our view, moral hazard only arises where the risk-controlling and risk-bearing entities have conflicting interests. In the case of an IP owner providing a license to another entity which exploits the IP, moral hazard would in principle not arise because both parties share the same interest, i.e. to develop the value of the licensed intangible.

28. What can happen in such a situation is that the intangible owner will want to ensure that the licensee exploits the licensed intangibles consistently with standards set by the licensor. For instance, it is typical for trademark license agreements to include clauses whereby the licensee commits to a certain level of marketing efforts in its market. Similarly, the licensee will want to ensure that the IP owner adequately maintains the licensed intangible. These generally are not moral hazard issues, because the interests of the parties generally are not conflicting. Rather, these are parameters of the collaborative relationship defined in the license agreement, whether between independent parties or associated enterprises.

Q3. In the example at paragraphs 90 and 91 how should moral hazard implications be taken into account under the arm’s length principle?

29. We do not think that moral hazard would come into play in this example. The most likely fact pattern is that S1 and S2 will share the same objective, i.e. maximizing the value of the trademark (S1 because it needs it for its exploitation, S2 because it is its own asset).
2.3 Risk-return trade-off

Q4. Under the arm’s length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognised, how should they be treated?

30. We believe that this question should be answered based on the arm’s length principle, and not based on various countries’ convictions about what may or may not be recognized. Our view is that under the arm’s length principle, transactions between associated enterprises should generally be recognized, including where the sole effect is to shift risk, except where one of the two situations described at paragraph 1.65 is met. Contractual terms should be the starting point and be respected to the extent that the actual conduct of the associated enterprises conforms to the contractual allocation of risks and that the latter is arm’s length.

31. In particular, we believe that transactions whose effect is to shift risk should be recognized as arm’s length where evidence from comparable risk allocations or reallocations between independent parties exists. Where no such evidence exists, then the question becomes whether third parties would have agreed to a similar risk shifting transaction in comparable circumstances. This is where notions such as control over the risk and financial capacity to bear risk come into play. In this respect, we support the guidance at paragraphs 9.11-9.33 of the TPG.

Q5. In the example at paragraphs 90 and 91, how does the asset transfer alter the risks assumed by the two associated enterprises under the arm’s length principle?

32. The asset transfer described in the example at paragraphs 90-91 entails a transfer of the trademark ownership risk from S1 to S2. S1 nevertheless continues to bear the exploitation risk, including risks associated with its role of licensee. Further, S1 bears operating risk associated with its marketing service function.

Q6. In the example at paragraphs 90 and 91, how should risk-return trade-off implications be taken into account under the arm’s length principle?

33. In the example at paragraphs 90-91, we believe that the risk-return trade-off is already taken into account by the fact that the royalty payable by S1 to S2 is set to equate to the value of a financing return. We assume that this value will be risk weighted. S2 will be compensated for its ownership risk and funding; S1 for its exploitation.

Q7. Under the arm’s length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk? If so:

a) Are there limits to the extent that the risk-return trade-off should be applied? For example, can the risk-return trade-off be applied opportunistically in practice to support transactions that result in BEPS (for example by manipulating the discount rates to “prove” that the transaction is economically rational)?

34. The response is embedded in the wording of the question: opportunistic manipulation should not be authorized, whether by taxpayers or tax administrations. This does not mean that risk-return trade-off may not be a valid argument to support the pricing of a transaction that legitimately and
effectively leads to the shifting of risk between associated enterprises. This should be determined on the merits of each factual situation.

b) Are there measures that can be taken in relation to the risk-return trade-off issue to ensure appropriate policy outcomes (including the avoidance of BEPS) within the arm’s length principle, or falling outside the arm’s length principle?

35. In our view, any such measure should be within the arm’s length principle, and should generally respect the transaction undertaken by the taxpayer, in other than exceptional circumstances.

3. Detailed comments on Section D.1: Identifying the commercial or financial relations

Paragraph 1

36. As noted at paragraph 1.11 of the TPG, “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.” We suggest the following edit:

As stated in paragraph 1.6 a “comparability analysis” is at the heart of the application of the arm’s length principle, and is Application of the arm’s length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises.

37. We further suggest that the following language from existing paragraph 1.33 should be reinstated:

In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.

Paragraph 2

38. In order not to set an unrealistic documentation threshold, we suggest the following edits be made to paragraph 2:

Establishing the conduct of the parties involves examination of all of the significant facts and circumstances surrounding how those enterprises interact with one another in their economic and commercial context to generate potential commercial value, how that interaction contributes to the rest of the value chain, and what the interaction involves in terms of the precise identification of the functions each party actually performs, the significant assets each party actually employs, and the significant risks each party actually assumes and manages.
Example at paragraph 4

39. We find the consequences of the example unclear. We think that the OECD should clarify that there would be no consequences if the comparable distributors also perform marketing activities.

Paragraph 5

40. We believe that the OECD should be careful not to give the impression that only “win-win situations” will be respected, irrespective of the realistically available options. We therefore propose the following edits:

In transactions between independent enterprises, the divergence of interests between the parties ensures (i) that contractual terms are concluded that reflect the interests of both of the parties, taking into account the realistic options available to them, (ii) that the parties will ordinarily seek to hold each other to the terms of the contract, and (iii) that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties taking into account the realistic options available to them.

41. In order not to set an unrealistic threshold for contractual documentation, we propose the following edits:

Where conduct is not fully materially inconsistent with contractual terms, further analysis is required to identify the actual transaction. Where there are material differences between contractual terms and factual substance, the conduct of the parties in their relations with one another, and what functions they actually perform, the assets they actually employ, and the risks they actually assume and manage, in the context of the consistent contractual terms, should ultimately determine the delineation of the actual transaction.

Example at paragraph 6

42. The consequences of the example are unclear to us: if S is a mere service provider, not a real licensee, then typically S should not retain the residual profits from the intangible. S’s compensation would typically be determined based on a cost based TNMM (Return on Total Costs). In such cases, the deductibility of a payment made to repatriate the intangible return to P should not be disallowed based on a view that this is not a “real royalty”. This should be clarified in the Draft (or the example should be removed if there is no agreement on what the consequences should be).

Paragraph 7

43. We think that the Draft should not suggest that the secondment of employees generally entails a transfer of know-how. See paragraph 1.95 of the interim Guidance on Transfer Pricing Aspects of Intangibles released in September 2014. We therefore suggest the following edit:

4 "The foregoing paragraph is not intended to suggest that transfers or secondments of individual employees between members of an MNE group should be separately compensated as a general matter. In many instances the transfer of individual employees between associated enterprises will not give rise to a need for compensation. Where employees are
For example, technical assistance may have been granted, or synergies may have been created through deliberate concerted action, or know-how may have been provided through seconded employees or otherwise.

44. **Paragraph 10: Economically relevant characteristics**

45. We support contractual terms being the first item on the list, although we would be concerned if this implied creating a backdoor for broad recharacterisation of contractual terms as part of the general comparability analysis.

46. For the reasons explained below we suggest deleting the language added to the definition of functional analysis:

   The functions performed by the parties to the delineated transaction, taking into account assets employed and risks assumed and managed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices.

47. First, risk management is already captured in “functions performed”.

48. The relevance of “how those functions relate to the wider generation of value by the MNE group to which the parties belong” is unclear to us: does this mean that the arm’s length compensation for the functions of a given entity would depend on the profitability of the group as a whole? Is this opening an avenue for a generalised application of profit split methods? This would no longer be consistent with the arm’s length principle which relies on market references. We also wonder whether this would mean tax authorities accepting that routine functions be loss-making in cases where the business as a whole is loss-making - a situation which currently is rarely accepted.

49. As noted in paragraph 1, this Draft deals with the first aspect of the analysis, i.e. “identify the commercial or financial relations between the associated enterprises and the conditions attaching to those relations in order that the controlled transaction is accurately delineated”. It does not deal with the second aspect, i.e. “compare the conditions of the controlled transaction with the conditions of comparable transactions between independent enterprises”. We therefore suggest deleting the reference to “industry practices” in this paragraph, as in our view it does not help in delineating the transaction.

**Paragraph 12: Options realistically available**

50. The proposed new language would state that “Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a better opportunity to meet their commercial objectives.” [emphasis added]. By contrast, the language in existing paragraph 1.34 of the TPG notes that “Independent enterprises, […] will only enter into the transaction if they see no alternative that is clearly more attractive.” [emphasis added]

51. We find the new wording to be overly prescriptive. It could be read as requiring all alternative options to be tested. We recommend that the OECD clarify that is not the intention.

seconded (i.e. they remain on the transferor’s payroll but work for the transferee), in many cases the appropriate arm’s length compensation for the services of the seconded employees in question will be the only payment required.”
52. Similarly, we propose the following edit:

[...]

Therefore, identifying the economically relevant characteristics of the transaction is essential in delineating the transaction and in revealing the range of characteristics taken into account in reaching the conclusion that the transaction adopted offers a better opportunity to meet commercial objectives than alternative options realistically available to them.

**Paragraph 13**

53. We propose the following edit:

The second way in which economically relevant characteristics or comparability factors are used in a transfer pricing analysis relates to the process set out in Chapter III of making comparisons between the controlled transactions and uncontrolled transactions in order to determine an arm’s length price range of prices or profit margins for the controlled transaction.

**D.1.1 Functional analysis**

54. We propose the following edit to paragraph 16:

This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed and managed by the parties to the transactions.

55. In effect, “risk management” is already captured in functions.

56. We note the proposed statement that it is “important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the parties with the rest of the group, and the contribution that the parties make to that value creation” [emphasis added].” We wonder whether this is intended to suggest a contribution analysis, or a generalised application of profit split.

**Paragraphs 17 and 18: Capabilities**

57. In the example at paragraph 17, we do not think that the functions of the associated enterprise would change, but rather that its cost structure would change. The question therefore is who, whether the logistics company or its intragroup customers, should bear the over-capacity costs. The response depends on the risk profile of the parties and would have consequences on the determination of their arm’s length compensation. For instance, if the logistics company is required to maintain overcapacity at the request and for the benefit of other group members, then its compensation should likely be determined based on full costs rather than on standard costs only.

58. The consequences of the example at paragraph 18 are unclear to us. We wonder whether the OECD is suggesting that a fee should be charged for synergy effects. If this is the case, we would welcome more guidance on who the fee should be charged to and how its price should be determined.
Paragraph 21: Fragmented activities

59. The proposed new guidance at paragraph 21 is potentially far-reaching as the description of fragmented activities in the Draft corresponds to very common practice in MNEs. We therefore recommend that the OECD clarify what the issue is and what the proposed consequences are.

60. We find the current draft to be inconsistent with the transactional focus of the OECD’s recognised transfer pricing methods (see existing guidance at paragraphs 3.9-3.12 and 3.37 of the TPG). Usually, in performing a comparability analysis, one would be looking for independent logistic companies as possible comparables for group logistic activities, independent marketing companies as possible comparables for group marketing activities, etc. We therefore believe that fragmentation, where it exists, is consistent with a transactional application of the TP methods and facilitates more than it impedes the identification of comparables. Independent comparables also are integrated in value chains, although all the information is not readily accessible to them and to tax administrations because it involves value creation by third parties. The fact that a transaction does not only involve members of the same group does not mean that it would not be part of a global value chain. For instance, independent automobile parts manufacturers work closely with automotive manufacturers. Parts manufacturers plan their production based on automotive manufacturers’ schedules, and they can have manufacturing units at the same site. The same is true for other manufacturing or logistic activities which can be integrated into the value chain of their customers. There is no reason to suggest that only group warehousing or sales functions would be part of value chains.

61. We wonder whether the OECD is in fact suggesting that coordination should be charged to the local affiliated distributor. If this is the case, this should be clarified. As indicated above, we find that the policy direction is unclear and fear that this type of guidance, if confirmed, would be conflicting with other OECD documents which tend to restrict the ability to charge intragroup services to affiliates. We also note the discussion of fragmented activities in the profit split discussion draft (paragraphs 26-28 and questions 14-16 of the profit split draft) which suggests (inappropriately in our view) that fragmentation would pose difficulties in relation to availability of comparables and refers to profit split as one possible solution.

D.2 Identifying risks in commercial or financial relations

Paragraph 38

62. In the example at the end of paragraph 38, Company A’s inventory risk depends on the demand from Company B. This is a market risk. Most companies deal with market risks. They may try to control this risk by influencing the demand (e.g. promoting the products to potential customers), by deciding the extent to which they will to take on risk (e.g. the level of inventories) and deciding whether and how to respond to the risk (e.g. transferring part of the risk to their distributors; or putting in place factory outlets). It is therefore incorrect in our view to state that “Company A would be unlikely to agree to take on substantial inventory risk, since it exercises no control over the inventory level while Company B does.” Rather, it should be noted that in this example Company A bears a market risk which should be reflected in the comparability analysis. In effect, Company A can be protected from market risk because 100% of its manufactured products are purchased by Company B, or it can bear market risk because Company B does not commit to purchase 100% of its production. Both situations can be consistent with the arm’s length principle, but these differing risk profiles
would need to be reflected in the comparability analysis and may attract differing levels of remuneration, i.e. this is a pricing issue, not a case for disregarding contractual terms.

63. We therefore suggest the following edits should be made to paragraph 38:

Between third parties, the assumption of risk without the control exerted by management over the risk is likely to be problematic because (i) it is difficult for the party assuming risk to evaluate the required additional expected return when the factors affecting the risk outcomes are determined by another party; and (ii) there would likely be considerations of moral hazard in an arm’s length situation were one party to assume risk without safeguards to manage the behaviour of the party creating its risk exposure.

At arm’s length, considerations of moral hazard may arise where one party bears risk that is controlled by another party and both have conflicting interests. In arm’s length transactions it generally makes sense for the parties to be allocated a greater share of those risks over which they have relatively more control. Control can be exercised directly by the risk-bearing party, or outsourced to another entity, without entailing the reallocation of the risk to the latter subject to the conditions of paragraph 9.24 being met. It is also possible in some situations to re-align the interests of both parties through contractual terms and/or compensation.

For example, suppose that Company A contracts to produce and ship goods to Company B, and the level of production and shipment of goods are to be at the discretion of Company B. In such a case, Company A would be unlikely to agree to take on substantial inventory risk, since it exercises no control over the inventory level while Company B does.

**Paragraph 40**

64. The relevance of some of the issues listed at paragraph 40 to the rest of the Draft is unclear to us, especially the ones in the 2nd bullet, 3rd sentence: “Do the specific risks relate to operational activities from which the risks arise?” and in the 5th bullet: “Does the party contractually assuming the risk either (a) perform the operational activities from which the risk arises, (b) manage the risks, or (c) assess, monitor, and direct risk mitigation?”

**Paragraph 43**

65. In order not to set an unrealistic documentation threshold, we suggest the following edits be made to paragraph 43:

[...] In line with the discussion above in relation to contractual terms (see Section D.1), it must be considered in each case-by-case basis whether an allocation of material risk contained in written contracts is consistent with the factual substance of the transaction as reflected in the conduct of the parties.
D.2.4 Potential impact of risk

Examples at paragraphs 51 - 52

66. While we understand the intellectual reasoning behind these examples, we find that they potentially create unnecessary administrative and compliance burdens. In the example at paragraph 51, the functions of the parent company are likely to be charged to the various affiliates through management fees or an allocation of headquarter costs.

67. Similarly, we find that the conclusions of the example at paragraph 52 are unclear. Read in combination with paragraph 75, it may be interpreted as suggesting that the subsidiary should first be allocated a profit split, and then deduct a high value adding service fee to compensate the role of the parent company. We think that this is unnecessarily complex given that, based on the facts of the example, such a method may well achieve the same net outcome for the subsidiary as the one which would be achieved by compensating it based on a TNMM.

68. More fundamentally, as explained in Section 1.2 of this letter, we are concerned with the apparent lack of clear policy direction in relation to synergies and integration benefits in the various OECD papers (existing and draft guidance).

D.2.5 Risk management

Defining “control over risk” and “risk management”

69. The notions of “control over risk” and “risk management” are defined at paragraph 55 of the Draft. We suggest these definitions should be brought upfront to the start of Section D.2 as they are essential to the understanding of the whole Section.

70. The Draft suggests that risks always follow the people functions managing them. We do not support the notion that risks should always follow functions in transactions between associated enterprises which are separate legal entities as this would mean generalizing the situations where a tax administration could disregard the contractual terms of a transaction and would go beyond the arm’s length principle.

71. Paragraph 55 indicates that

Risk management comprises three elements: (i) the capability to make decisions to take on or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

72. It further states that “where a decision is made to outsource risk mitigation as described in (iii), control over risk would require capability to assess, monitor, and direct the outsourced measures that affect risk outcomes, together with the performance of such assessment, monitoring, and direction.” We understand that where the risk-bearer has such capability and actually exercises the assessment, monitoring and direction functions, then it has full control of the risk and the risk allocation will be
respected. The Draft however does not indicate what the outcome of the analysis will be in case the risk-bearer satisfies performs (i) and (ii) but outsources (iii) and does not exercise any assessment, monitoring or direction functions over (iii). In such cases, we do not think that the risk allocation should automatically be disregarded.

73. For instance, assume an arrangement is put in place within an MNE group whereby operating affiliates outsource the management of their currency exposure to a central treasury function within the group. In practice, it is very unlikely that each affiliate will monitor and control the performance of this function by the central treasury on a daily basis. The Draft can be read as implying that in such a case, because of the lack of monitoring activities by the operating affiliates, all the gains or losses are attributable to the central treasury function. On the other hand, paragraph 69 seems to recognize that such a function can be seen as a service provision to the operating affiliates. We urge the OECD to clarify what the desired interpretation is.

74. We believe that Section D.2.5 should be read in the context of the guidance at paragraphs 9.11-9.33 and suggest that a cross-reference to that guidance be clearly incorporated in Chapter I. In particular, we think that in applying the arm’s length principle, the role of comparables should not be omitted: where data evidence a similar allocation of risk in comparable uncontrolled transactions, then the contractual risk allocation between the associated enterprises is regarded as arm’s length. We see control as a relevant, although not determinative factor to hypothesise what risk allocation would have been achieved by independent parties in cases where there are no comparables.

D.2.6 Actual conduct

Paragraph 60

75. The example at paragraph 60 seems to rely on the existence of “stringent audit programmes, extensive testing protocols, mandatory training and a culture of improvement” to reallocate risk to the supplier. This is extremely disturbing because such audit programmes, protocols, training, and culture of improvement are today a standard in most industries. Third party suppliers are selected based on the existence and quality of such processes and activities and their efficiency in minimizing the risks of product quality defect. This is all the more true in cases where the distributor who selects the supplier is the one bearing the product recall risk. The distributor may control product recall risks by selecting a supplier who has an effective quality management programme and the interests of both the supplier and the distributor can converge. The example at paragraph 60 seems to us to be based on an erroneous interpretation of the notion of moral hazard.

Paragraph 61

76. We agree that contractual allocations should only be respected to the extent that the conduct of the parties is consistent with the contractual terms. We however do not support the notion which stems from paragraph 61 that control would be the key to characterise the conduct of the parties as there is no evidence that at arm’s length a risk-bearer always performs the functions which are defined in the Draft as “control”. We think that the examples at paragraphs 44 and 45 are more appropriate examples of mismatches between contracts and actual behaviour.

77. We see control over risk as a relevant, although not determinative factor to hypothesise what risk allocation would have been achieved by independent parties in cases where there are no
comparables. We would not support the incorporation of a “risk follow functions” standard in the TPG for associated enterprises which are separate legal entities. There is a long-lasting debate as to whether the Authorized OECD Approach to attributing profits to permanent establishments should be incorporated in the TPG. We recognise the roots and underlying rationales for conflicting arguments in this respect, but do not support such a solution which in our view would ignore the realities of separate legal entities and unduly restrict contractual freedom. That being said, we note that the proposed definition of control in the Draft is not the same as the one of the “significant people functions relevant to the assumption and/or management (subsequent to the transfer) of risks” in the OECD Report on the Attribution of Profits to Permanent Establishments.5 Further, the latter report acknowledges that “The significant people functions relevant to the assumption of risk and the significant people functions relevant to the economic ownership of assets will vary from business sector to business sector (e.g. such functions are unlikely to be the same for an oil extraction company and a bank) and from enterprise to enterprise within sectors (e.g. not all oil extraction companies or all banks are the same).”

Paragraph 62

78. We suggest the following edit to the 2nd sentence:

At arm’s length the carrying on of those functions would affect the terms agreed by the parties, including compensation risk assumption.

79. We disagree with the rest of the paragraph which states that

In an arm’s length situation, the distributor would find it difficult to determine the additional return it should seek to recover from the supplier if it were to assume stock obsolescence risk since the tools by which that risk can be managed, and the activities which influence that risk, are determined by the supplier. The distributor would need safeguards provided by the ability to control the risk were it to assume the risk. There would likely be considerations of moral hazard in an arm’s length situation were the distributor to underwrite stock obsolescence without such safeguards, since it may encourage the supplier to maximise its returns at the expense of the distributor. Therefore, at arm’s length the risk is more likely to be assumed by the party which manages the risk or which, if risk mitigation measures are outsourced, controls the risk.

80. In effect, we think that these sentences are confusing the distributor’s own risk (which, as indicated above, is controlled by the distributor’s decision to take on the risk and to select suppliers with effective quality programmes) and the supplier’s own risk. We suggest they should be deleted.

Paragraph 63: Differentiating the risks of the asset owner from the risk of the exploitation and the control functions associated with each

81. The last sentence states that

If the asset owner does not have capability to control risks associated with the exploitation of the asset, the legal owner of the asset is in substance providing only financing equating to the cost of the asset, and should be remunerated on that basis.

82. We note that disputes can arise as to whether the value contributed by the asset owner should be determined by reference to the costs or the arm’s length value of the asset (in case both differ). Under the alternative options realistically available theory, arm’s length value would seem more appropriate.

83. Further, we understand that the OECD, through its interim guidance on intangibles and this Draft, is exploring the possibility for low functional asset owners to be remunerated through a financial return. We note that should that be the case, such financial return should be risk weighted. Furthermore, we think that the above quoted statement should not be read to imply that the asset owner needs to have day-to-day management of the asset exploitation. The decisions which lead to exercising control over the asset owner’s own risks are not the same as the decisions which lead to exercising control over the licensee’s exploitation risks.

Paragraph 65

84. In order not to set an unrealistic compliance threshold, we suggest the following edits:

In a transfer pricing analysis, it is very important to conduct a full functional and comparability analysis to assess the significant contributions by all of the associated parties to the activities to which the risks relate. Based on the full functional and comparability analysis, it is may be appropriate to consider separately the appropriate risk-weighted return to the cash investment and any risk premium that may be associated with risk management.

85. Further, we note that the performance of the risk management function can in appropriate circumstances be compensated at arm’s length based on a CUP or one-sided method. There should be no implication that risk management always attracts residual profit (or loss). This is consistent with the draft guidance at paragraphs 69 and 74.

Paragraph 69

86. We agree with the proposed language at paragraph 69. In particular, we agree that depending on the functional analysis, it is possible that the centralised treasury function operates either on its own account or on behalf of the operating subsidiaries. This is consistent by analogy with the existing guidance at paragraphs 9.154-9.160. However, we fear that the rest of Sections D.2.5-D.2.6 may not be consistent with paragraph 69.

Paragraphs 71-72

87. While we understand what the OECD is trying to achieve with this paragraph, we think that overly prescriptive language should be avoided. We suggest the following edits to the first sentence:

71. In risk transfers between associated enterprises the risk-return trade-off may be one element should not be used on its own to justify the appropriateness of any risk transfer. In particular, however, a risk transfer not supported by functions should be critically reviewed. In a debt factoring arrangement between independent enterprises,
for example, the seller discounts the face value of its receivables in return for a fixed payment, and so accepts a lower return but has reduced its volatility and laid off risk. The factor will often be a specialised organisation which takes on risk and has functional capabilities to manage the risk and generate a return from the opportunity. Neither party will expect to be worse off as a result of entering into the arrangement, essentially because the factor is more capable of managing the risk than the seller and terms acceptable to both parties can be agreed. However, it does not follow that by analogy any exchange of potentially higher but riskier income for lower but less risky income between associated enterprises is justifiable for transfer pricing purposes at arm’s length. Where the party taking on risk does not have the capabilities to manage its risks and generate a return from the opportunity, this may lower the price it would be prepared to pay compared to the situation in which it was able to manage its risks, and may mean terms acceptable to both parties could not be agreed.

72. In analysing the transfer of risk, it is relevant to consider whether the arrangement provides the opportunity for both parties to the arrangement to enhance or protect their commercial or financial position on a risk-adjusted basis (the return adjusted for the level of risk associated with it). This means that risk transfer is likely to happen only if the transferee is well placed or better placed to manage risk than the transferor. Circumstances meriting particular scrutiny include those where the transferee has no risk management capability, and those where risk management is performed by the transferor.

Paragraph 74

88. We agree with the proposed language at paragraph 74 but fear that Sections D.2.5-D.2.6 may not be consistent with it.

Paragraphs 75-76

89. We agree that risk is an important element of comparability analyses. However, we find that paragraphs 75-76 set an unrealistic standard. It is generally impossible to obtain information on the performance of the risk management function by comparables. Keeping the paragraph as is may lead to the rejection of the vast majority of benchmarking analyses, and possibly a generalisation of profit split for lack of comparables. We do not think that a profit split method should apply in examples 52 and 74 just because of the performance of some risk management functions. We therefore suggest that these paragraphs be more realistically redrafted as follows:

75. In these situations the analysis of risk helps to determine comparability. Where potential comparables are identified, it is relevant to determine whether they include the same a comparable level of risks and management of risks. For example, the exclusivity negotiated for certain toys outlined in the example in paragraph 52 may mean that the price is not comparable to otherwise similar goods provided without exclusivity. In the manufacturing service example in paragraph 74, if quality control is performed by the transacting party rather than by the service provider, then the service fee may need to be adjusted.
76. Some controlled and uncontrolled parties and transactions are likely to present a common set of risks. For example, distributors may present a fairly homogeneous set of risks such that the functions of the controlled distributor can reliably be benchmarked by reference to profit margins of uncontrolled distributors. However, such an assumption needs to be tested in the functional analysis by establishing how the functions of the controlled party contribute to risk management, the impact of the risks, and whether those functions, and other functions, differ to the functions of uncontrolled parties.

Paragraph 77

90. See comments above under paragraph 51 of the Draft.

Paragraph 78

91. In determining whether a party should be entitled to unanticipated profits or losses, contractual terms should be the starting point. If contracts are consistent with the actual conduct of the parties and are consistent with what independent parties would have agreed in comparable circumstances, then they should be respected. We do not think that this determination should be made solely based on which party controls the risk.

4. Detailed comments on recharacterisation

D.4 Non-recognition

Paragraph 84

92. We support the cautious language at paragraph 84.

93. We believe that it is essential to confirm that non-recognition should be limited to exceptional cases only. We are very concerned that the existing paragraph TPG 1.64 was deleted from the Draft and urge the OECD to reinstate it in the final guidance. We think that TPG 1.64 makes important and valid points. Deleting it would send the wrong signal to the business community and tax authorities.

Paragraph 86

94. We note that, between independent parties also, it is possible and it happens that “the performance of activities can be conducted by a different legal entity to the one which owns assets or contractually bears risks.”

D.4.2 The concept of fundamental economic attributes of arrangements between unrelated parties and commercial rationality

95. The Draft introduces the notion of “fundamental economic attributes of arrangements between unrelated parties” as a test for determining whether a transaction shall be recognised or disregarded. As noted at paragraph 88, this notion is broader than the one of commercial rationality which has been in the TPG since 1995.
Paragraph 89

96. Paragraph 89 states that

An arrangement exhibiting the fundamental economic attributes of arrangements between unrelated parties would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted (the return adjusted for the level of risk associated with it) basis, compared to other opportunities realistically available to them at the time the arrangement was entered into [emphasis added].

97. We think that it is in effect essential that the test be “compared to other opportunities realistically available to them at the time the arrangement was entered into”. We suggest that this critical statement should be reinforced in the Draft, in order not to lead to the undesirable interpretation that only win-win situations would be recognized, as this would not be arm’s length and not be realistic.

Paragraph 90-92

98. The example at paragraphs 90-92 assumes that S2 has employees with capability to assess, monitor, and direct the use of the trademark by Company S1, and costs of $10m, but no capability to exploit the trademark, and that in accordance with the interim guidance in the latest OECD drafts, the royalty payable by S1 to S2 is set to equate to the value of a financing return. Accordingly, it is not a case where there is a lack of economic substance.

99. The example does not say whether the lump sum payment of $400 million paid by S2 to S1 in exchange for the transfer is arm’s length. In our view, an assumption that this payment is arm’s length should be added to the example, noting that, consistently with the guidance at paragraph 9.86 of the TPG, the entirety of the commercial arrangement between the parties (including the sale of intangibles and the subsequent licensing back) should be examined in order to assess whether the transactions are at arm’s length.

100. The question which is posed at paragraph 91 in substance is whether the transaction is commercially rational from the perspective of S1 and would have taken place between independent parties. This is a highly factual and case specific question. We therefore suggest that the OECD should refrain from concluding negatively. Rather, we suggest that the OECD note that in such a case the commercial or financial rationale of the transaction for S1 may need to be explained. For instance, it is possible that the arrangement provides S1 with a favorable financing opportunity (noting that the return “given up” to S2 equates with a financing return), possibly better than the other options realistically available to S1. The response will largely depend on the determination of the price of the asset sale by S1 to S2 and subsequent royalty to be paid by S1 to S2, i.e. a financial calculation of the risk weighted return for S1 and S2. Other business reasons may exist to support such a transaction from the perspective of S1.
101. This example reminds us of the “crown jewel” example which was in the 2008 Discussion Draft on Business Restructurings.\textsuperscript{6} The “crown jewel” example was the subject of contentious debates at the public consultation. It was removed from the final guidance in Chapter IX of the TPG.

102. In summary, we think that the situation described in paragraphs 91-92 is consistent with the arm’s length principle (subject to the pricing of the original intangible transfer to be arm’s length) and does not raise any moral hazard issue. This should be explicitly acknowledged at paragraph 92. The question whether the transaction would have taken place between independent parties is highly factual and no definite or prescriptive answer to this question should be given in this example based on the limited available factual background.

D.4.3 Consequences of non-recognition

103. At paragraph 93, the Draft provides very limited guidance as to the consequences of non-recognition. Should the final guidance confirm the significant broadening of the circumstances where non-recognition may apply as proposed in this Draft, this would entail a dramatic potential for disputes. We would urge the OECD to provide appropriate guidance on the consequences of non-recognition.

104. At a minimum, the guidance should state that the transaction substituted for the non-recognised transaction should be an alternative characterisation or structure which comports as closely as possible with the facts of the case, and which reflects the results that would have been derived had the transaction been structured in accordance with the commercial reality of independent parties. The guidance should include a cross-reference to, or be aligned with, the existing guidance at TPG 9.187.

5. Comments on Part II: Options for some special measures

5.1 General comments

105. We appreciate the opportunity to comment on special measure at an early stage of the project, when we understand that no decision has been made yet as to what special measure, if any, will be adopted by the OECD. We understand that the proposed special measures are at a very early stage and that significant work will be undertaken by the Working Party to assess each of the proposed options and design the one(s) which might possibly be adopted. We think that adopting and designing special measures is a complex and important undertaking which requires a careful prior review of policy and legal considerations.

106. We find that the consideration of special measures is still premature, in that it is still unclear what situations exactly need to be addressed which are not already addressed through other papers, and what the fundamental principle underlying a special measure should be.

107. First, we believe that given the possibly far-reaching implications of implementing any of the proposed special measures, the OECD should do a serious scoping exercise and be significantly more specific on what residual BEPS risks remain once it will have amended the guidance on intangibles in Chapter VI, on risks and on non-recognition in Chapter I, and on Transfer Pricing Documentation.

\textsuperscript{6} Paragraph 216 of the 2008 Draft.
including Country-by-Country reporting. We do not think that the three sentences at paragraph 3 provide a convincing demonstration and scoping of what exactly is needed.

108. There is a clear risk of overlapping or “overkill” with the series of proposals which are currently being discussed both by WP6 and by other working groups. We recommend that the OECD first finalise its work on the TPG, CFC rules, and interest deductions, then precisely identify situations involving “residual BEPS risk” and perform a solid scoping exercise, before making any decision as to whether special measures are effectively needed and if so which ones, how to appropriately delineate them and how to design them.

109. It is also essential to the integrity of the process to determine whether the OECD is aiming for consensus measures or for a “menu” of options that countries may decide to incorporate in their domestic legislation and bilateral treaties. Given the approach taken in this preliminary Draft, we fear that the risk of ending up with a “menu” is real.

110. The OECD invites comment (at question 7) on the order in which the measures should apply. In our view,

- If a special measure is built within the arm’s length principle, then the general guidance in the TPG should apply first, and the special measure should apply by exception to well targeted situations. In such cases, the integrity of the arm’s length principle would require that taxpayers retain the possibility to demonstrate that their controlled transaction complied with the arm’s length principle in order to avoid the application of a special measure, i.e. the general principle should prevail over the special measure.

- If a special measure is built outside the arm’s length principle, then it would likely operate independently from it, e.g. based on domestic law provisions.

111. Secondly, we respectfully but strongly disagree with the proposal that

At this stage, it is not critical to determine whether a potential measure is on one side or the other of the boundary, but the aim is to consider the effectiveness of the measure. It should also not be assumed that, if special measures are introduced that go beyond the arm’s length principle, double taxation may result.

112. To the contrary, we believe that it is essential to clarify upfront what the principles are upon which the OECD is relying to develop potential special measures, as this will govern what the scope of the measure should be, its threshold for application, and its design and implementation plan.

113. In our view, special measures can only be said to be within the arm’s length principle if they are solidly grounded in Article 9 of the Model Tax Convention, which provides that tax administrations may adjust the profits of associated enterprises if conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises. The OECD should refrain from importing into the arm’s length principle and TPG special measures which are not arm’s length, as this would weaken the principle itself and jeopardize the broad consensus about its interpretation.
114. It follows that any special measure which would restructure controlled transactions irrespective of whether independent enterprises would have agreed to a transaction comparable to the one undertaken by the taxpayer should be regarded as non-arm’s length.

115. Special measures outside the arm’s length principle that countries may find necessary to deal with specific BEPS risks should be appropriately narrowly targeted and have sufficiently clear thresholds for application in order not to entail excessive discretion in application.

116. Moreover, the design of a special measure as being within or outside the arm’s length principle could have fundamental consequences on the modalities to eliminate double taxation, coordination with treaty and domestic provisions, and in some cases penalties. In this respect, the OECD invites comments (at question 8) as to whether mechanisms should be available for eliminating double taxation, even if the rules are considered to be anti-abuse measures. Our view is that economic or juridical double taxation is never desirable and should always be eliminated. We understand the need to make abusive situations unattractive; this in our view is the role of the heavy penalties which are typically embedded in anti-abuse measures. If the OECD designs and encourages the adoption of special measures within or outside the TPG, it should at the same time design the legal and administrative mechanisms to ensure that such special measures will not lead to double taxation.

5.2 Option 1: Hard-to-value intangibles

117. We think that the second sentence of Option 1 should be amended to delete the reference to “the potential for systematic mispricing” and use instead more neutral language.

118. We understand the phrase “hard-to-value intangibles” to refer to situations where the projections used in valuing an intangible, e.g. using a discounted cash flow approach, are highly uncertain. This can be the case where an in-process intangible is transferred at a point in time where the risk of failure of the remaining R&D steps is still significant, and/or where the commercial prospects are still very uncertain. We believe that hard-to-value intangibles raise two main issues:

- First, the determination of what party(ies) (transferor, transferee, or both) bear(s) the risk associated with the uncertain valuation of the transferred intangible;
- Secondly, the question of a potential information asymmetry between tax administrations and taxpayers in relation to the determination of the projections used to support the valuation.

119. In our view, the first issue should be resolved following the general guidance on risks in the TPG. The second question may possibly lead the OECD to Option 1 as a Special Measure. Accordingly, we think that Option 1 could possibly be designed as an administrative measure within the arm’s length principle if it is appropriately targeted to tackle information asymmetry.

120. In this respect, we find that the current proposal under Option 1 for a rebuttable presumption is reasonable to tackle cases where the taxpayer failed to document contemporaneously the projections and to make them available to the tax administration.

121. In designing Option 1, there should be a time limit on the ability of a tax administration to adjust the price of a transferred intangible.
122. We note that if Option 1 is endorsed, it would be essential for it to be capable of bilateral or multilateral agreement in order to eliminate the double taxation which would otherwise follow. It should be made clear for instance that in the event where the price of a transferred intangible is revised by the tax administration of the country of the transferor following guidance to be developed under Option 1, then the country of the transferee should eliminate double taxation, e.g. by re-determining the amortization / depreciation of the transferred intangible and/or any future capital gain or loss made by the acquirer on a further transfer of the intangible. Symmetrically, if the country of the transferee adjusts the price of an acquired intangible following Option 1 guidance, then the country of the transferor should eliminate double taxation by reducing the taxable capital gain, irrespective of whether the gain was made during a year which is now closed under domestic limitations.

123. Furthermore, Option 1 should not defeat the general guidance on hindsight. We think that the guidance at TPG 3.73 should remain the norm, with Option 1 being a possible departure from the norm to deal with information asymmetry in relevant cases.

5.3 Inappropriate returns for providing capital

124. In line with our comment above, we believe that the OECD should more precisely identify what the problematic situations are and further scope the work in relation to “inappropriate returns for providing capital”. Given the importance of the measures which are considered, we think that it is not sufficient to note that

In other circumstances, however, the application of the arm’s length principle may be difficult and may not address the allocation of excess or unanticipated returns to the capital-rich, asset-owning company.

125. At a minimum, the OECD should provide for a hierarchy of the various measures it proposes, as a single situation may be tackled by several of the proposals currently examined by the OECD. For instance, a situation involving a capital-rich intangible owner which does not perform any function may be tackled through:

• Guidance in the revised Chapter VI, with the currently shaded portion of the interim draft suggesting a risk-adjusted return on the investment with little indication as to where the residual return would go;

• Proposed revised guidance in Chapter I on risks, suggesting that the residual profit or loss derived from the investment risk might go to the party performing the risk management functions;

• Proposed revised guidance in Chapter I on non-recognition, if the conditions of paragraphs 90-92 are met, suggesting that in certain conditions the intangible may be considered as not having been transferred to the capital-rich intangible owner;

• Proposed special measure(s).

126. This is notwithstanding the possible impact of other drafts such as the one on interest deductions and the one on CFC rules depending on the facts of the case. The risk of overlap and
confusion is serious, and the result could be double, triple, or more taxation if there is no clear consensus as to where the profits should be taxed.

5.3.1 Option 2: Independent investor

127. Option 2 is premised in the notion that

An investment in the company which has no or little capability to generate a return from the asset might be considered by an independent investor to carry higher risk with lower returns than an investment in a company with such capability.

128. In our view, this assumption ignores the fact that an investment in a company which is a licensee, does not own the licensed intangible, and does not have the funding to maintain and further develop it may in fact carry the higher risk.

129. Option 2 if adopted would be outside the arm’s length principle, as it is not grounded in market realities. We do not think that it should be included in the TPG.

5.3.2 Option 3: Thick capitalisation

130. Similarly, we think that Option 3, which relies on a predetermined capital ratio, could only be developed outside the arm’s length principle and should not be included in the TPG.

5.4 Option 4: Minimally functional entity

131. We understand and support the notion that substance is required in intragroup arrangements, and that purely artificial arrangement need to be addressed. That being said, Option 4 strongly echoes the yet unresolved, contentious issue whether only functions create value or whether the provision of capital and bearing of risks are valuable inputs to the business.

132. Furthermore, we think that the OECD, recognising that minimally functional entities may already be tackled by other pieces of proposed guidance, including (but not limited to) the proposed new guidance on non-recognition, should clarify what the need for Option 4 is and precisely identify the situations where it would apply instead of, not in addition to, other guidance. Alternatively, the OECD could indicate that Option 4 is a substitute for other pieces of draft guidance which would then need to be removed.

133. More fundamentally, we are very concerned that Option 4 illustrates the apparent lack of clear policy direction and consensus as to where the “excess profits” should be taxed: should they be reallocated to the entities exploiting the intangible, to the parent company, or to the entity providing the funding? This is a fundamental stake at the heart of the BEPS project. Lacking a clear direction and consensus, we fear that the combination of the various OECD discussion drafts has the potential to create unprecedented uncertainty and double taxation - or more. The risk that taxpayers will be caught in the middle of governments competing for more tax basis is extremely high. We believe that the role of the OECD is to build global consensus based on clear principles to avoid this kind of battle.

134. From a principle perspective, we note that reallocating the “excess profits” to the entities exploiting the intangibles would be a defensive, non-arm’s length measure. Reallocating the “excess profits” to the parent company would likely be a CFC measure. In our view, none of the proposals under Option 4 belong to the TPG.
5.5 **Option 5: Ensuring appropriate taxation of excess return**

135. Option 5 would be a CFC measure, clearly outside the arm’s length principle, which should not be incorporated in the TPG.
Submission on the
OECD discussion draft on
‘BEPS Actions 8, 9 and 10
Revisions to chapter 1 of the
transfer pricing guidelines’

6 February 2015
Ms Marlies de Ruiter  
Tax Treaties, Transfer Pricing and Financial Transactions Division  
OECD Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris Cedex 16  
France

By e-mail to: taxtreaties@oecd.org

6 February 2015

Ref: OECD public discussion draft on follow up work on BEPS action 4: Interest Deductions and other financial payments

Dear Ms de Ruiter,

I am pleased to communicate the views of Ibec and its members on the public discussion draft published by the OECD on ‘BEPS Actions 8, 9 and 10 Revisions to chapter 1 of the transfer pricing guidelines’. Ibec represents the interests of Irish business including indigenous and multinational enterprises and SMEs, spanning all sectors of the Irish economy. Ibec and its sector associations work with government and policy makers at national and international level to shape business conditions and drive economic growth. Ibec is also a member of BIAC and Business Europe and broadly supports the views communicated by these partners in their submissions on the OECD discussion draft.

Comments

Ibec supports work under the OECD’s BEPS programme to ensure that transfer pricing outcomes are in line with value creation. This stands to benefit countries which have real and substantial multinational presences within their countries including Ireland. Below are the comments and reflections of Ibec on the discussion draft.

Part I – Revision of the provisions of Chapter 1, Section D of the Transfer Pricing Guidelines

Ibec supports the thrust of the OECD’s proposed revisions set out in Part I of the discussion draft. In particular, we welcome guidance on:

(i) The accurate delineation of the actual transactions based business reality, encompassing actual conduct and actual allocation of risk and that contractual terms should reflect this reality.

(ii) The specification of associated risks and allocations of risk to risk management (as long as it does not determine a disproportionate increase of compliance burden for tax payers), and

(iii) The non-recognition of transactions which lack the fundamental attributes of arrangements between unrelated parties (to the extent that adequate measures are included to ensure proper application to cases arising).
We welcome extension of the guidelines as bringing clarity and greater certainty to business. These guidelines must not, however, lead to tax authorities taking an unnecessarily stringent view in assessing transfer pricing transactions that clearly fall outside BEPS. It is important that the purpose of the BEPS project and the alternative purposes of rewriting transfer pricing guidelines are not confused. There is a risk that examples in the discussion draft are excessively broad currently and may run the risk of confusing these separate objectives. Specific examples related to BEPS should be included in the draft to ensure there is no ambiguity and that genuine transactions are not unnecessarily burdened.

We are also concerned that some of the new standards set out in the draft, such as the proposed principles for identifying risks, are onerous and will be extremely hard to comply with in practice. Therefore, we are concerned that even compliant taxpayers making their best efforts will fail or be seen to fail to comply with these new standards and hence face an increasing risk of re-characterisation. Changes should limit re-characterisation of transactions in accordance with their purported substance. Changes must also affirm that smaller nations do not have re-characterisations forced upon them, leading to greater disputes and potential for double taxation.

Part II: Special Measures

Regarding the potential special measures included in Part II; their inclusion at such an undeveloped stage will create further uncertainty for taxpayers in addition to the understandable uncertainty involved in the process. We believe that the analysis of commercial and financial relations set out in Sections D1 and D2 followed, where necessary, by the application of non-recognition in Sections D3 and D4 should be sufficient to ensure that transfer pricing outcomes are in line with value creation and that therefore special measures are not required.

In addition, it is our belief that the documentation and information sharing required under action 13 of the BEPS plan on transfer pricing documentation and country by country reporting should reduce risks around information asymmetry. The documentation required by Action 13 will give tax administrators the necessary tools and information to conduct risk assessments and commence audits and obviates the need for special measures. If this is not sufficient, General Anti Avoidance rules should be sufficient in any case.

If, however, special measures are to exist, then there must be a clear and consistently applied set of criteria for their application and an unambiguous gateway for entry to them. The lack of clear observable criteria for them or transparent processes around special measures may lead to countries interpreting provisions differently. This in effect could result in uncertainty, complexity, inconsistent application, significant increases in disputes and potentially double taxation. Additionally, these special measures if envisaged should be used only after the application of normal transfer pricing rules. Circumstances must not arise where individual tax administrations choose to ignore guidelines and apply special measures in the first instance.

Finally, where special measures are introduced significant consideration must be given to preventing the possibility of double taxation due to disputes arising from their application. Processes in their application must include a mechanism to avoid this prospect and add clarity and certainty in addition
to uniformity across jurisdictions. Given the complexity of the situations likely to be covered by special measures we believe that the existing mutual agreement procedures would be severely stretched in trying to cope with the additional work. We therefore suggest that if special measures are to be implemented, one of the requirements should be that any resulting cross-border disputes are granted priority by tax administrations.

We therefore suggest that if special measures are to be implemented, one of the requirements should be that tax administrations intending to use them are required to discuss in advance their appropriateness with the corresponding treaty party tax administration and that any resulting cross-border disputes arising are granted priority through mutual agreement procedure.

**Conclusion**

Ibec supports and welcomes the thrust of the OECD’s proposed revisions set out in Part I of the discussion draft. We are concerned, however, there is a risk that examples in the discussion draft are excessively broad currently and may run the risk of confusing the separate objectives of the BEPS project and providing clarity in transfer pricing guidelines. We are also concerned that some of the new standards set out in the draft, such as the proposed principles for identifying risks, are onerous and will be extremely hard to comply with in practice.

We do not see the prima facie necessity of the special measures outlined briefly in section 2. Their inclusion at such an undeveloped stage will create further uncertainty for taxpayers in addition to the understandable uncertainty involved in the process. We believe the guidelines set out in section 1 along with the application of other changes from the broader BEPS project should be sufficient to ensure that transfer pricing outcomes are in line with value creation and that therefore special measures are not required.

Yours sincerely,

_______________________
Fergal O’Brien
Head of Policy and Chief Economist
fergal.obrien@ibec.ie
Prepared by the ICC Commission on Taxation and the ICC Commission on Customs and Trade Facilitation

Summary
International businesses face difficulties regarding the valuation of goods due to diverging customs and tax rules regulating transactions between related parties. ICC calls for more alignment and puts forward concrete proposals to secure harmonized tax and customs valuation of transactions between related parties in an international context.
### Highlights

- Recognition by the customs administration that businesses which establish prices between related parties in accordance with the arm’s length principle (as per Article 9 OECD Model Tax Convention) have generally demonstrated that the relationship of the parties has not influenced the price paid or payable under the transaction value basis of appraisement and consequently that the prices establish the basis for customs value.

- Recognition by the customs administration of post-transaction transfer pricing adjustments (upward or downward). This recognition should be applicable for adjustments made either as a result of a voluntary compensating adjustment – as agreed upon by the two related parties – or as a result of a tax audit.

- It is recommended that in the event of post transaction transfer pricing adjustments (upward or downward), customs administrations accede to review the customs value according to either of the following methods as selected by the importer: application of a weighted average duty rate, or an allocation according to specific codes of the customs tariff nomenclature.

- It is recommended that in the case of post-transaction transfer pricing adjustments (upward or downward), companies be relieved from:
  a) The obligation to submit an amended declaration for each initial customs declaration
  b) The payment of penalties, as variations of the transfer price

- It is recommended that customs administrations recognize that the functions and risks undertaken by the parties as documented in a transfer pricing study following an OECD transfer pricing methodology are crucial to the economic assessment of the circumstances of the sale.

- Recognition of the acceptability of relevant transfer pricing documentation by the customs administration as evidence that the price paid for imported goods was not influenced by the relationship of the parties.
Introduction

As the world business organization, the International Chamber of Commerce (ICC) confirms that multinational companies, from all sectors and in every part of the world, face difficulties with respect to the valuation of goods. These difficulties arise because transactions between related parties are subject to both customs and fiscal examinations and are thereby bound by differing rules and contradictory interests. ICC believes these examinations should yield the same value and that a resolution to the problem is in the interests of all concerned.

There are two reasons for this problem:

1. Tax and customs administrations, even within one country and sometimes within the same government department, have different approaches: tax administration focuses on intra-group sales’ prices that may be perceived as higher than they should be; whereas customs authorities control imported goods for which prices may be perceived as lower than the market price. While both administrations seek to achieve the same goal, which is arm’s length pricing, revenue interests in the transaction still remain at odds with each other.

2. Tax and customs administrations often set rules independently for the same transaction/good. Tax authorities seek conformity with the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines which have been largely codified in many countries. This set of rules provides guidance on the application of the arm’s length principle for the valuation of cross-border transactions between associated enterprises, whereas customs authorities conform to Article VII of the General Agreement on Tariffs and Trade (GATT) Valuation Code.

This dichotomy, present in both developed and developing countries, creates a climate of uncertainty and complexity compounded by economic globalization. It also leads to increases in implementation and compliance costs, absence of flexibility in the conduct of business operations, and furthermore creates a significant risk of penalties. Indeed, even when a company complies with both the OECD guidelines/principles and the World Trade Organization (WTO) Valuation Agreement, there is no guarantee that there will not be a dispute between two countries or two administrations in the same country on the determination of the arm’s length price. This means that valuation conflicts can arise not only prior to but also after an audit.

Given that intercompany transactions account for more than 60% of global trade in terms of value, the divergence of customs and transfer pricing valuation presents an obstacle to the liberalization of trade and inhibits international development for companies of all sizes.

Key features

Although numerous points of divergence can be listed between customs and tax approaches, it is important to stress that points of convergence also exist. Therefore, while it may not be necessary to change WTO rules or the OECD guidelines we believe that the two can and should be aligned by finding a common way of interpreting the arm’s length principle. As a basic principle, we recommend that tax administrations assess and appreciate how the enterprise has arrived at the declared customs value (and vice versa – as the case may be - the customs administration assess and appreciate how the enterprise has arrived at the transfer price) prior to issuing a formal tax or duty assessment. If the conflict between the enterprise and the relevant fiscal administration cannot be resolved, then the tax administration and the customs administration of the respective country should work in concert and attempt to harmonize valuation determinations.

A recommended method to accomplish harmonization of customs and income tax requirements is
for customs administrations to use information contained in transfer pricing studies. It will help determine whether the price between related parties is acceptable for customs valuation. Indeed, ICC notes that the World Customs Organization (WCO) has already considered the appropriateness of transfer pricing documentation in Commentary 23.1 of the Technical Committee on Customs Valuation (TCCV). To the extent a customs administration believes it needs additional data that is readily available in the normal course of business to supplement standard transfer pricing study data sets, those data elements should be clearly defined and published (see Proposal 6).

This approach considers that it is not currently conceivable to try to find solutions outside existing and well-recognized principles, nor is it realistic to seek a total harmonization of customs and tax rules or even to impose one’s view onto another. Furthermore, the business community believes that creating yet another set of rules will not solve these problems. ICC therefore recommends a focus on how these principles can be more closely aligned and made acceptable to both governmental authorities and the private sector. This document is offered as an input from the business sector to international organizations working on these issues.

The goals of the proposals that follow are to:

- Secure harmonized tax and customs valuation of transactions between related parties in an international context
- Clarify rules for both companies and administrations
- Suppress or at least reduce financial impact linked to divergent valuation
- Simplify regulations

And thereby:

- Reduce compliance costs to companies
- Eliminate the risk of penalties resulting from disputes arising from divergent views taken by customs and tax authorities
- Streamline intercompany operations and facilitate international business

**Proposals**

Although Advance Pricing Agreements (APAs) can resolve tax valuation concerns, APAs are often very rigid, time- and cost-consuming, and not appropriate for businesses that continually evolve. Often, APA’s are also not a viable option for small and medium sized enterprises or for transactions that are not material in size.

Accordingly, in order to enable more documentation supportive of valuation validation, ICC proposes the following additional options to derive customs value:

**Proposal 1**

**Recognition by the customs administration that businesses which establish prices between related parties in accordance with the arm’s length principle (as per Article 9 OECD Model Tax Convention) have generally demonstrated that the relationship of the parties has not influenced the price paid or payable under the transaction value basis of appraisement, and consequently that the prices establish the basis for customs value.**

The customs value is normally based on Article VII of the GATT agreement 1994 which states that, in article I, Rules on Customs Valuation:
1. The customs value of imported goods shall be the transaction value, that is the price actually paid or payable for the goods when sold for export to the country of importation adjusted in accordance with the provisions of Article 8 (…)

Thus, customs authorities prefer to determine customs duties on the sales price of imported goods, which is deemed to represent an arm’s length value. When the seller and the buyer are related, and arm’s length pricing comes into question, transaction value can still be used for customs valuation purposes if the importer can demonstrate that the declared transaction value: 1) meets the circumstances of sale test or 2) by comparison with test values.

As explained below in article I, Rules on Customs Valuation of GATT Article VII:

1. The customs value of imported goods shall be the transaction value (…) provided (…) 3 (d) that the buyer and seller are not related, or where the buyer and seller are related, that the transaction value is acceptable for customs purposes under the provisions of paragraph 2.

2. (a) In determining whether the transaction value is acceptable for the purposes of paragraph 1, the fact that the buyer and the seller are related within the meaning of Article 15 shall not in itself be grounds for regarding the transaction value as unacceptable. In such a case the circumstances surrounding the sale shall be examined and the transaction value shall be accepted provided that the relationship did not influence the price. If, in the light of information provided by the importer or otherwise, the customs administration has grounds for considering that the relationship influenced the price, it shall communicate its grounds to the importer and the importer shall be given a reasonable opportunity to respond. If the importer so requests, the communication of the grounds shall be in writing.

(b) In a sale between related persons, the transaction value shall be accepted and the goods valued in accordance with the provisions of paragraph 1 whenever the importer demonstrates that such value closely approximates to one of the following occurring at or about the same time:

(i) the transaction value in sales to unrelated buyers of identical or similar goods for export to the same country of importation; (ii) the customs value of identical or similar goods as determined under the provisions of Article 5;

(iii) the customs value of identical or similar goods as determined under the provisions of Article 6;

With regard to 2(b), the Agreement at 2(c) requires that an inquiry under 2(b) must be undertaken only at the request of the importer and that the tests are only for comparison purposes. The Interpretative Notes to 2(b) require that the test values must be previously determined, pursuant to an actual appraisement of imported merchandise. If there are no previous importations of identical or similar merchandise that were appraised by customs authorities under the transaction, deductive or computed value methods, there may not exist any test values that will be accepted by the customs administration. Therefore, it is common practice to evaluate the circumstances surrounding the sale in relation to the above 2(a).

The Interpretative Notes to 2(a) provide examples of how to evaluate the circumstances of sales in order to satisfy the customs administrations that the relationship of the parties did not influence the transaction value. The Interpretive Note to Article 1, 2(a) of GATT Article VII reads as follows:
2. **Paragraph 2(a) provides that where the buyer and the seller are related, the circumstances surrounding the sale shall be examined and the transaction value shall be accepted as the customs value provided that the relationship did not influence the price.** It is not intended that there should be an examination of the circumstances in all cases where the buyer and the seller are related.

Such examination will only be required where there are doubts about the acceptability of the price. Where the customs administration has no doubts about the acceptability of the price, it should be accepted without requesting further information from the importer. For example, the customs administration may have previously examined the relationship, or it may already have detailed information concerning the buyer and the seller, and may already be satisfied from such examination or information that the relationship did not influence the price.

3. Where the customs administration is unable to accept the transaction value without further inquiry, it should give the importer an opportunity to supply such further detailed information as may be necessary to enable it to examine the circumstances surrounding the sale. In this context, the customs administration should be prepared to examine relevant aspects of the transaction, including the way in which the buyer and seller organize their commercial relations and the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price. Where it can be shown that the buyer and seller, although related under the provisions of Article 15, buy from and sell to each other as if they were not related, this would demonstrate that the price had not been influenced by the relationship. As an example of this, if the price had been settled in a manner consistent with the normal pricing practices of the industry in question or with the way the seller settles prices for sales to buyers who are not related to the seller, this would demonstrate that the price had not been influenced by the relationship. As a further example, where it is shown that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time (e.g. on an annual basis) in sales of goods of the same class or kind, this would demonstrate that the price had not been influenced.

Consistent with Commentary 23.1 of the WCO Technical Committee on Customs Valuation (TCCV), for importers that establish related party pricing policies in accordance with the OECD Transfer Pricing Guidelines and provide the necessary transfer price documentation, such documentation should be considered a solid basis on which customs administrations can evaluate the circumstances surrounding the sale. The OECD Guidelines are based on sound underlying economic principles designed to result in arm’s length prices being charged the same result sought by customs administrations when determining that prices have not been influenced by the relationship.

Consequently, consistent with Commentary 23.1, in certain instances ICC recommends that importers who set prices in accordance with the OECD Transfer Pricing Guidelines have demonstrated that the relationship between the buyer and the seller did not influence the price.

Accordingly, the arm’s length principle (Article 9 OECD Model Tax Convention) may be directly aligned with the rules for determining the acceptability of transaction value under the circumstances of sale test. This alignment should be recognized by customs administrations and doing so will set up a convergence between the OECD and WTO rules with regard to the value of transactions between related parties.
Moreover, there are many situations where voluntary or a fortiori imposed adjustments were not foreseeable at the time the import declaration had been made. The propositions 2 and 3 concern cases where the customs implications of any such transfer pricing adjustment need to be duly dealt with.

**Proposal 2**

**Recognition by the customs administration of post-transaction transfer pricing adjustments (upward or downward).** This recognition should be applicable for adjustments made either as a result of a voluntary compensating adjustment – as agreed upon by the two related parties – or as a result of a tax audit.

Post-transactions adjustments that affect product price are permitted by both the OECD guidelines and WTO customs valuation rules. These post-transaction adjustments can be done for a variety of reasons, including voluntary adjustments, but also for year-end adjustments when trying to achieve a pre-agreed profit range at the end of a year or period. However, the procedures to report such adjustments to customs administrations are determined by local rules, and adjustments are often disregarded by customs when the importer adjusts the purchase price downwards.

When such post-transaction adjustments that affect price – i.e. compensating adjustments – are made pursuant to an OECD transfer pricing methodology, these adjustments should be recognized by customs administrations as part of the price paid for the goods, and consequently as an element of the transaction value of the goods.

Companies should be permitted to perform customs value adjustments without being required to set up a provisional valuation procedure or being subject to penalties due to valuation adjustments.

**Proposal 3**

**It is recommended that in the event of post-transaction transfer pricing adjustments (upward or downward), customs administrations accede to review the customs value according to one of the following methods as selected by the importer.** These methods being applicable to the value of the goods impacted by the adjustment:

- **Application of the weighted average customs duty rate:** the weighted average customs duty rate is calculated by dividing the customs duties' total amount for the year by the respective customs value total amount for the same year. This may include the possibility of a lump-sum adjustment at the end of the year. For example, if at the end of the year, the transfer price adjustments result in an additional payment to the seller, then we recommend that the importer be able to report this lump-sum amount. That way customs will be able to allocate this to all entries declared within the year and the duty adjustment will be the weighted average duty rate.

- **Allocation of the transfer pricing adjustment, according to the nomenclature code, and to information provided by the importer or customs authorities disclosing all commodity codes and all relevant import data available in their national statistics.**
Proposal 4

It is recommended that in the case of post-transaction transfer pricing adjustments (upward or downward), companies be relieved from:

- The obligation to submit an amended declaration for each initial customs declaration. Instead, a single recapitulative return referring to all the initial customs declarations would be lodged.

- The payment of penalties, provided the amended declaration is voluntarily timely filed with customs. In fact, these variations depend on various factors which have absolutely nothing to do with an intention to evade customs duties.

Proposal 5

It is recommended that OECD transfer pricing methods are recognised as an acceptable framework for evaluation of the circumstances of sale by customs administrations with an acknowledgement of the following elements:

- Identical or similar goods: Many transfer pricing studies apply comparable pricing methods. In most cases, such methods rely on the similarity of the functions performed, assets used, and risks assumed as well as similarities between the imported goods. Transfer Pricing studies also require geographic and temporal comparability, although it may be necessary to use regional and multi-year comparable if more precise comparables are unavailable. Customs administrations should recognize the use of comparable profit methods and regional and multi-year comparables where appropriate.

- Corporate legal entities (performing specific functions and adding value within a group): Transfer pricing studies evaluate the functions of each company in the related party group, and the risks undertaken by each party to make an economic assessment of arm’s length prices between related parties. Customs administrations should similarly recognize that understanding the functions and risks undertaken by each entity provides valuable information for evaluation of the circumstances of the sale following sound underlying economic principles.

Proposal 6

Recognition of the acceptability of transfer pricing documentation by the customs administration as evidence that the price paid for imported goods was not influenced by the relationship of the parties.

Tax transfer pricing documentation is a tax legal requirement almost all over the world. Its content is largely aligned across the countries and can hence be considered fairly standard. It normally includes all of the information required to analyze the circumstances of sale, the parties involved, the added value, and the functions performed by each party. Should a customs administration believe that additional data – readily available in the normal course of business – beyond that commonly found in transfer pricing documentation is necessary to assess whether or not the prices are influenced by the relationship of the parties, ICC recommends that the additional customs data requirements be clearly defined and published in advance by the customs administration to enable incorporation of those requirements into transfer pricing documentation to serve both purposes.
Conclusion

This policy statement is an update of the 2012 ICC Policy Statement on Transfer Pricing and Customs Value, prepared by the ICC Commission on Taxation and the ICC Committee on Customs and Trade Regulations. A comprehensive approach on the nexus between transfer pricing and customs value is becoming of increasing importance for cross-border trade. It is to be expected that many around the world will contribute to this topic in the foreseeable future and ICC is ready to work with intergovernmental organizations such as the Organisation of Economic Co-operation and Development (OECD) and the World Customs Organization (WCO) on this highly complex and contentious area within the global tax and customs world.

ICC will continue to monitor developments in this important area and will issue an update of this policy statement if needed.
About The International Chamber of Commerce (ICC)

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy.

With interests spanning every sector of private enterprise, ICC’s global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the G20 and other intergovernmental forums.

Close to 3,000 experts drawn from ICC member companies feed their knowledge and experience into crafting the ICC stance on specific business issues.

www.iccwbo.org
Comments to the OECD Discussion Draft on BEPS Actions 8, 9 and 10
“Revisions to Chapter I of the Transfer Pricing Guidelines
(including Risk, Recharacterisation and Special Measures)”

The International Chamber of Commerce (ICC), as the world business organization speaking with authority on behalf of enterprises from all sectors in every part of the world, welcomes the opportunity to provide comments on the Discussion Draft on BEPS Actions 8, 9 and 10 which sets out proposals to modify the OECD Transfer Pricing Guidelines (the “Guidelines”) relating to risk allocation, recharacterisation and special measures. ICC acknowledges that transfer pricing must follow the business reality, reflecting actual conduct and actual allocation of functions and risks, and that contractual arrangements should reflect this. While ICC therefore appreciates modifications to the Guidelines where this will enhance certainty and clarity in this area for both taxpayers and tax administrations, it is noted that extensively expanding the effect of the Guidelines could result in greater uncertainty and thus poses high risks of double taxation.

ICC is concerned that taxpayers may no longer rely on contractual terms they have entered into with both related and unrelated parties. Even in an arm’s length situation it is common for a contractual agreement to be varied marginally in its actual conduct without an amendment of the agreement. This does not necessarily mean that the validity of contractual terms or the entire agreement is brought into question. Only where contractual terms are absent or misleading should they be clarified in the context of actual conduct. ICC would recommend a more forceful commitment to this position.

A further concern in analyzing commercial or financial relationships is the difficulty of documenting the options that were realistically available at the time. This would create a substantial compliance burden. In practice, clear and complete documentation of the alternative options available at the time an agreement is entered into will rarely be available. Consequently, with the benefit of hindsight – in the context of a tax audit conducted many years later – a transaction might be considered to represent a realistically available alternative while it would not have been considered so at the time. In addition, the compliance burden becomes enormous if the transaction undertaken and all alternative options, including the option not to undertake the transaction, have to be considered and documented for each and every transaction. ICC would recommend guidance around materiality in order to narrow such a broad scope.

ICC welcomes the desire for enhanced certainty and clarity around risk and its allocation in particular. However, the Discussion Draft comprehensively reviews people functions and risk, but does not provide guidance concerning the contribution to economic value attributable to capital and to legal rights. ICC recommends providing additional guidance in this respect. ICC would also welcome clearer guidance on practical issues such as dealing with materiality and the nature of certain risk factors, particularly as not all risks have a material economic impact on pricing in arm’s length transactions.

Furthermore, in the context of non-unique contributions, even in a highly integrated business, it is important that they be rewarded consistently with their value creation rather than an assumed right to residual profit, even in cases where perfect comparables are not easily available. Similar concepts should also apply to the sharing of risks. For example if a particular type of risk could normally be addressed with a comparability adjustment (when the tested transaction differs from comparables for that specific risk), the fact of being shared within a global value chain or highly integrated business should not automatically result in the sharing of residual profit to that particular risk.

ICC further welcomes that the criteria for non-recognition are further specified and that the Discussion Draft stresses every effort should be made to recognize the actual transaction. However, the Discussion Draft states that fragmented activities are under common control, but is silent on the fact that directors are required to act in the best interest of the individual entity, not the MNE group. ICC recommends providing additional guidance in this respect, e.g. on the impact of the generally accepted business judgment rule, in the context of non-recognition.
ICC strongly supports paragraphs 102-103 of the Discussion Draft as they acknowledge the benefits of interaction as well as enhanced cooperation between tax and customs authorities. However, ICC believes that the OECD should take the opportunity to further strengthen section D of Chapter 1. As highlighted in the ICC Policy Statement on Transfer Pricing and Customs Value (see annex), a stronger alignment of the interpretation of the arm’s length principle and harmonisation of valuation determination would help reducing legal uncertainty and conflicts. In this respect, ICC encourages the OECD to make further recommendations regarding the acceptability of tax principles, methods, and documentation for Customs purposes.

Finally, ICC notes that the special measures mentioned in the Discussion Draft partially disregard the arm’s length principle for the sake of achieving a specific outcome. ICC believes it is premature to propose any special measures until the impact of the other proposals can be evaluated and until the special measures and their impact have been more thoroughly assessed. ICC also suggests that such measures should be considered only after the application of transfer pricing rules. Otherwise, the underlying principle itself would be brought into question.

At a practical level, some of the proposals set out in the Discussion Draft are onerous. The most rigorous measures and standards that might ordinarily be applicable to only a handful of taxpayers are applied broadly, and this poses a real threat of misuse of such provisions in case of the vast majority of taxpayers, not engaged in BEPS. In some Asian countries, for example, recharacterisation of transactions or functional profiles (e.g. capital to loan or contract service provider to intangible developer) is a common occurrence and the Discussion Draft would provide more latitude to the Revenue authorities to take recourse to such measures that should, by definition, be applied sparingly and with a great degree of caution.

Furthermore, were such measures to be used, ICC suggests the inclusion in the guidance of some form of ‘gateway approach’, which would stipulate certain criteria e.g. low/no tax outcomes, tax only motive, minimum substance etc. be met before special measures could be applied to certain transactions. While ‘gateway’ approaches in themselves are not troublesome, there would need to be safeguards to ensure that any proposed gateways are not unfairly biased for or against particular industries, taxpayers or business models. ICC also notes that thresholds will already be scrutinized under Action 13 on aspects of country-by-country reporting and, thus, any thresholds must be fully considered and be sufficiently flexible in order not to unfairly impact a given taxpayer. The amount of work required to find globally suitable solutions may be disproportionate and it may be impossible to achieve consensus which leaves again the arm’s length principle as the best available approach.

ICC also recommends that the guidance would mandate Tax Administration’s pre-disclosure to impacted Treaty Parties’ Competent Authorities of an intention to use special measures.
The International Chamber of Commerce (ICC) Commission on Taxation

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy. Founded in 1919, and with interests spanning every sector of private enterprise, ICC’s global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.
6 February 2015

Andrew Hickman
Head of the Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris, Cedex 16
France

RE: Application of Transfer Pricing Guidelines to CIV Industry

Dear Mr. Hickman:

ICI Global,¹ on behalf of our collective investment vehicle (CIV)² industry members, appreciates that business and governments both will benefit from additional, thoroughly considered, and carefully crafted transfer pricing guidance. We support both the OECD’s effort and the comments being submitted today by BIAC. This letter summarizes a few issues of particular concern to the CIV industry.

First, the final report on these BEPS Action items, we submit, must stress that a properly-applied arm’s length standard remains the most accurate pricing measure for related party transactions. Similarly, transfer pricing analyses must be based upon facts rather than theory. No “one-size-fits-all” approach – particularly one based on economic theory – can account properly for the significant differences between industries, and between firms within a single industry. The financial services industry in general, and the CIV industry in particular, present factual issues that are very different from those presented by other industry sectors. Business reality, as the discussion draft recognizes, is paramount.

¹ The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.1 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

² A CIV is defined for this purpose consistently with the OECD’s Report entitled “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles” (the “CIV Report”). Specifically, paragraph 4, page 3 of the CIV Report defines CIVs as “funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established.”
Second, for similar reasons, we strongly oppose the use of formulary apportionment if any reasonable basis exists for performing a transfer pricing analysis. The various activities performed by an asset manager in the CIV industry create different types of risks and do not contribute equally to the manager’s success. Risk management and profitability considerations are different for actively-managed funds that “pick” stocks, for example, than they are for indexed-based funds that seek to mirror the performance of a basket of stocks.

Third, we must emphasize that risk considerations in the financial services industry often are dictated by regulatory requirements. Under the European Union’s UCITS IV Directive and the AIFMD, for example, the management company remains responsible and liable for the operation of the CIV, even when certain activities, such as portfolio management, are delegated to another entity either located within that country or another country. Importantly, the management company may not delegate its functions to other entities to the extent that it can be considered to be a “letter-box” entity; the management company must have measures in place that permit it to monitor effectively the entity to which it has delegated functions.

Fourth, we are concerned that many of the extensive changes that are proposed to the transfer pricing guidelines, including those discussed in BIAC’s comments, could increase rather than decrease the number of tax disputes with compliant taxpayers. The BEPS timeline, unfortunately, does not provide sufficient time for considering thoroughly the ramifications of these changes and addressing them fully. Consequently, while we appreciate the reasons for the BEPS timeline, we urge that this very productive ongoing dialogue continue beyond the end of 2015.

Fifth, and related to the point immediately above, we reiterate our previously-expressed strong support for including mandatory binding arbitration in the BEPS Action 14 recommendations. Transfer pricing controversies already are disproportionately expensive to resolve and create significant potential for cross-border disputes and double taxation. Without the possibility of mandatory binding arbitration, the likelihood of un-resolvable disputes surely will increase.

Finally, and of central importance to asset managers, it is essential that the guidelines not apply to the financial services industry a “special measure” based upon “appropriate” returns on capital or levels of capital. The capital requirements for financial services industry firms are unique; not only is capital an essential component of financial services firms’ business models, but capital adequacy requirements often are imposed by our regulators.

* * *

Please feel free to contact me (at lawson@ici.org or 001-202-326-5832) at your convenience if you would like to discuss this issue further or if we can provide you with any additional information. My colleagues Karen Gibian (at kgibian@ici.org or 001-202-371-5432) and Ryan Lovin (at ryan.lovin@ici.org or 001-202-326-5826) also may be called upon for assistance.

Sincerely,

Keith Lawson
Senior Counsel – Tax Law

cc: TransferPricing@oecd.org

Attachment
Overview of the CIV Industry

ICI Global’s recommendations on these Action Items are informed by CIV industry experiences in the global marketplace and the resulting tax controversies. In this context, it is instructive to consider the nature of a CIV, the reliance on third-party service providers, the roles and responsibilities of these service providers, and the organization of the CIV manager.

The Nature of a CIV

A CIV is a pooled investment vehicle widely used by individuals to cost-effectively access the securities markets. The important advantages provided by CIVs include professional management, asset diversification, liquidity, and robust governmental regulation and oversight.

All functions of the CIV, which does not have employees of its own, are performed by third-parties. The asset manager that has created the CIV often will perform many of these services. A CIV’s officers typically will be employees of the asset manager. The typical CIV is overseen by a board of directors or trustees responsible for ensuring that the CIV is operated in accordance with its organizational documents, local law, and the best interests of its investors.

A CIV’s investment objective (e.g., stocks or bonds; country-specific, regional, or global; etc.) is prescribed in its offering document. Most CIVs disavow any interest in exercising any control over a company in which they invest. The CIV’s portfolio management team decides which specific securities to buy and sell and initiates the securities trades.

Investors’ interests in a CIV are acquired either directly from the CIV (with the purchase reflected directly on the CIV transfer agent’s/recordkeeper’s books) or through a third-party distributor. All CIV investor transactions are effected at the CIV’s net asset value (NAV), which is determined each day by calculating the CIV’s assets and liabilities and dividing by the number of outstanding interests. Because of this precise calculation requirement, certainty regarding a CIV’s tax liabilities is essential.

CIVs may be organized for distribution to one or more specific types of investors (e.g., individuals, pension funds, corporates, etc.). Depending on the type of targeted customer, different methods will be utilized for promoting the CIV and distributing CIV interests. Intermediaries (e.g., banks, broker dealers, financial planners) typically are heavily involved in the distribution process.

The tax treatment provided to CIVs effectively recognizes that CIVs do not carry on business activities. To ensure that CIV investors receive tax treatment comparable to that provided to direct investors, for example, countries typically provide some mechanism to exempt a CIV’s income from tax; the exemption mechanism may be an express tax exemption or a targeted tax deduction for amounts distributed to investors. The only tax borne by the typical CIV on its portfolio transactions is any withholding tax that may be imposed when the CIV is a nonresident investor.
A CIV is separate and distinct from the asset manager that created it. The CIV and the asset manager have different owners, their assets are totally separate, and they bear no responsibility for each other’s liabilities (including tax liabilities).

Management Companies and Other Service Providers to CIVs

The typical CIV asset manager offers its customers a wide range of financial products and provides them with an array of valuable services. The products may include CIVs, other investment pools (e.g., hedge funds) that are not widely-held, insurance, and banking services. The services provided, in addition to offering these products, may include distribution, investment education, investment advice, wealth management, and/or estate planning.

The services that an asset manager may provide to a CIV could include:

- portfolio selection (which may involve portfolio managers (PMs), analysts, and research assistants);
- asset acquisition and disposition (often through multiple securities dealers);
- assistance in arranging asset custody (typically through a global custodian and regional/local subcustodians);
- regulatory compliance;
- investor recordkeeping (through a “transfer agent”); and
- investor communications (including transaction confirmations and periodic account statements).

Many asset managers create separate entities to distribute CIV interests. These distributors may contact investors directly or work through unrelated third-parties (e.g., broker-dealers). Because the global CIV industry is highly intermediated (i.e., CIV interests typically are acquired through third parties), arm’s-length pricing comparables are available for “in-house” distribution activities.

Many management companies operate globally – although their specific activities may vary widely. Companies may distribute their products locally, regionally, or globally. Some may invest globally – even if they distribute only locally or regionally. Still others may consolidate various functions in one (or more) locations to achieve economies of scale.

The manner in which a management company is organized and/or structures its operations also may vary widely. Even within one country, a company may create separate entities; different business lines subject to different regulatory regimes and/or supervised by different regulators frequently will be placed in separate entities. Operations in multiple countries likewise often will be performed by separate companies.

Particularly within the heavily-regulated financial services industry, regulatory considerations often will be the primary (if not exclusive) driver for structuring decisions. Local regulatory requirements, for example, frequently require that a locally-organized CIV be managed by a local management company. To the extent that one country’s regulatory regime applies to an entire entity, companies often will establish separate subsidiaries so that the applicable regulatory regime will apply only to the relevant business activities. When different jurisdictions have different, and potentially inconsistent, regulatory requirements, it often is necessary to set up separate entities (e.g., distributors) in each
jurisdiction. Separate entities become even more important when country-specific securities licenses or other permissions are required.

**CIV Industry Competitiveness**

The CIV industry is extremely competitive. CIVs routinely advertise their performance (investment return) both in real terms and relative to their competitors. Independent research firms (e.g., Morningstar) often are a primary source for the data required to make these comparisons.

Performance and reputation are key for CIVs and their asset managers. CIVs that generate strong returns and outperform competing investment products are rewarded with shareholder investment inflows. CIVs that underperform face shareholder redemptions. Because an asset manager’s fees are calculated based upon assets under management (AUM), managers are incentivized to generate strong performance.

Perhaps the biggest driver on performance (other than portfolio management) is the fee paid by a CIV to its manager. Because all fees paid by a CIV come directly from the CIV’s assets, fees have a direct and negative impact on performance. The more a CIV pays in management fees, the lower its investment return. The CIV industry, therefore, is extremely price-sensitive.

Management companies also are incentivized to keep fees low. The lower the CIV’s expenses, the higher the returns, and the greater the investor demand for the CIV. The larger the CIV, the higher the gross management fee.

**Management Company Expense Considerations**

Management companies seek to control all of their expenses. Business efficiency, including consolidating functions operationally and/or geographically, play an important role in cost containment. Costs between related parties are charged by applying the arm’s-length standard.

All management company operations, importantly, do not have the same impact on profitability. In the CIV industry, a management company’s reputation and success are driven largely by the attractiveness of the CIVs it offers to investors. Developing innovative products (e.g., exchange traded funds) or identifying new investment opportunities (e.g., micro cap stocks) can generate growth. Because performance is key, however, portfolio management (e.g., stock picking) is a key profitability driver. Administration and infrastructure costs (e.g., regulatory compliance such as legal services and accounting, transfer agency, custodial, and information technology costs) are very important to a successful operation and may constitute a significant portion of a CIV’s operating costs – but they have less impact on a CIV’s performance.
Mexico City, February 6, 2015

Via e-mail
transferpricing@oecd.org
Mr. Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration

Dear Mr. Hickman,


1) Comments to paragraph 22

22. [1.45 – modified slightly] Controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised.

Paragraph 22 states that the identification and consideration of the material risks assumed by each party is a necessary condition for the functional analysis to be complete. However, no criterion is provided about when should a risk be considered material. Although the concept of materiality may be a matter of a case by case evaluation, further criteria should be put forward in order to avoid controversies derived from subjective evaluation.
2) Comments regarding moral hazard

The document requires commentaries around the concept of moral hazard. Specifically, it states that:

“[…]The term is used (for example in paragraphs 62 and 67) to introduce the concept that unrelated parties would seek to avoid moral hazard that may arise in situations where one party assumes a risk without the ability to manage the behaviour of the party creating its risk exposure. The concept extends to the safeguards or incentives that unrelated parties may incorporate into contracts between them in order that interests are better aligned and moral hazard is reduced or avoided.

[…]

Between associated enterprises, however, the existence of common control will generally mean that there is no need to contractually align incentives in order to ensure that one party will not act contrary to the interests of the other. Instead, the associated enterprises may operate collaboratively in order to maximise MNE group profits. The adverse effects of moral hazard may in practice not occur.

The document requires comments on the following questions:

1. Under the arm’s length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?

Moral hazard is a direct consequence of a divergence of interest between the parties involved. As the document states, the existence of common control will generally mean that there is no need to contractually align incentives.

Moral hazard should not be considered as a factor unless there is proof that the parties behave as third parties, as such situation would be the existence of moral hazard unless contractual incentives are created that align the interests of the parties.

2. How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing
intellectual property or market opportunities affect the analysis of transactions between associated enterprises?

Such situation may not be relevant between related parties in general. Although frequently related parties do not share insights about core competencies other than a need-to-know basis, associated enterprises frequently share the information that is needed to develop the core activities of the group in each market, as that is a natural way for the multinational enterprise to add value for the corporation as a whole.

3) Comments regarding Paragraph 84

84. Because non-recognition can be contentious and a source of double taxation, it is recommended that every effort is made to determine the actual nature of the transaction and apply arm’s length pricing to the accurately delineated transaction, and that non-recognition is not used simply because determining an arm’s length price is difficult. [..]

Although it is accepted that non-recognition should be used only under specific circumstances, the lack of sufficient guidance makes the application of the principle highly contentious and potentially subject to arbitrary judgement. We consider that non-recognition is not a sound approach for transfer pricing purposes unless specific and practical guidance is provided regarding why and when it should be applied.

4) Comments regarding Paragraphs 88 and 89

88. The concept of the fundamental economic attributes of arrangements between unrelated parties gives greater definition to the test of commercial rationality which underpinned the discussion of non-recognition in the 1995 and 2010 versions of these Guidelines. That commercial rationality test requires consideration of whether the actual arrangements differ from those which would have been adopted by independent parties behaving in a commercially rational manner, but can be challenging to apply since, as the Guidelines themselves acknowledge, controlled parties do enter into arrangements which differ from those adopted by independent parties. That test can be difficult to apply since it is hard to delineate what independent enterprises behaving in a commercially rational manner would have done. In addition, the test can be interpreted as having two legs (commercial
rationality and whether the structure adopted practically impedes the determination of an appropriate transfer price) which must be met, as opposed to interpreting the pricing impediment reference as an inherent quality of an arrangement lacking commercial rationality. The two legs can lead to the assertion that if you can find a price, the arrangement is not commercially irrational, with a resulting emphasis on the quality of the process of determining an “appropriate” price rather than on whether it is appropriate in the first place to try to find a price for something which lacks the fundamental economic attributes of arrangements between unrelated parties.

89. In order for the transaction as accurately delineated to be recognised for transfer pricing purposes, the transaction should exhibit the fundamental economic attributes of arrangements between unrelated parties. An arrangement exhibiting the fundamental economic attributes of arrangements between unrelated parties would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted (the return adjusted for the level of risk associated with it) basis, compared to other opportunities realistically available to them at the time the arrangement was entered into. If the actual arrangement, viewed in its entirety, would not afford such an opportunity to each of the parties, or would afford it to only one of them, then the transaction would not be recognised for transfer pricing purposes. In applying the criterion, it is relevant to consider whether there exists an alternative for one or more of the parties, including the alternative of not entering into the transaction, which does provide the opportunity to enhance or protect their commercial or financial positions. It is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a pre-tax basis. The criterion may be illustrated by the example in the following paragraph.

Comparability is a key component of the arm’s length principle. Its reliance on third-party data makes the principle difficult to apply but it also limits the subjectivity associated to the diversity of financial or economic approaches available for the evaluation of an intercompany transaction.

The concept of “fundamental economic attributes” as proposed in the previous paragraphs, proposes –without sufficient guidance- an “override” to the comparability approach in which the arm’s length principle relies. Its use may result in speculation and the use of hypothesis that cannot be demonstrated in practice.
Its use by the tax administration may be a potential source of uncertainty as taxpayers may face a tax liability even if they maintain documentation that includes a reasonable application of a method and comparables. As a consequence, we believe that such concept should not be incorporated at all.

5) Comments on point 3 of the Special Measures (general section)

3. However, in preparing the revised guidance in response to the mandate of the BEPS Action Plan, it has been recognised that even if these changes to the transfer pricing guidance are introduced, certain BEPS risks may remain. These residual risks mainly relate to information asymmetries between taxpayers and tax administrations and the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities (MFEs). This capital can then be invested in assets used within the MNE group, creating base eroding payments to these MFEs. Therefore, special measures have been considered to address these risks.

It should be noted that the BEPS initiative includes a significant increase in the documentation requirements to be faced by multinational enterprises. Such increase reduces the asymmetries mentioned in the previous paragraph. The application of special measures may not be justified under such situation.

6) Comments on hard-to-value intangibles

Option 1: Hard-to-value intangibles (‘HTVI’)

Action 8 of the BEPS Project requires the development of transfer pricing rules or special measures for transfers of hard-to-value intangibles. The need for a measure arises because of the potential for systematic mispricing in circumstances where no reliable comparables exist, where assumptions used in valuation are speculative, and where information asymmetries between taxpayers and tax administrations are acute. The most significant issues can arise where it is difficult to verify the assumptions on which a fixed price is agreed sometimes several years before the intangible generates income.

The measure could target circumstances where the taxpayer:
• fixes the price either as a lump sum or as a fixed royalty rate on the basis of projections without any further contingent payment mechanism; and
does not contemporaneously document those projections and make them available to the tax administration.

The effect of the measure would permit the tax administration to presume that a price adjustment mechanism would have been adopted and as a result may rebase the calculations based on the actual outcome, imputing a contingent payment mechanism. A contingent payment mechanism may include any price adjustment made by reference to contingent events, including the achievement of financial thresholds such as sale or profits, or of development stages.

The presumption may be rebuttable under certain conditions. Those condition (sic) could be designed to include situations where:

- the taxpayer can demonstrate the robustness of its ex ante projections used in determining the fixed price, its experience of making such projections reliably in similar circumstances, and the comprehensiveness of its consideration of reasonably foreseeable events and other risks.
- the outcome does not differ from projections used ex ante to calculate the fixed price by more than [xx]% or the actual profitability of the transferee does not differ from anticipated profitability by more than [xx]%.

The lack of a contingent mechanism may not be coherent with the arm’s length principle under certain circumstances, however, neither is an adjustment based on actual results. If third parties where to agree to a contingent mechanism, the triggering factor should be based on events whose probability of occurrence is foreseeable at the moment the transaction is carried out.

If this special measure is to be considered, the tax administrations should base their analysis on the information available to the taxpayer at the moment the transactions were closed, not on actual outcomes.

Contrary to the suggestion of the document, we believe it is for the tax administration rather than for the taxpayer to demonstrate that the adjustment is based on reasonably foreseeable events and other risks. The special measure in itself presumes that the taxpayer did not make a reasonable effort in determining an arm’s length price. Hence, the idea that the presumption of the tax administration is rebuttable may not be in practice a real defense alternative for the taxpayer if the latter has to demonstrate that his analysis was reasonable rather than the tax administration being required to demonstrate otherwise.
Furthermore, if such a special measure were to be utilized, it may become a measure prone to arbitrary judgement if no clear-cut criteria are provided regarding terms like “robustness”, “experience” or “comprehensiveness”.

7) Comments on Thick Capitalisation

Option 3: Thick capitalisation

This option depends on determining and applying a thick capitalization rule based on a pre-determined capital ratio. The effect of this option would be to determine the amount of capital in excess of this ratio, and then to deem interest deductions on the excess capital which would reduce the profitability of the capital-rich company and produce deemed interest income in the company providing the excess capital.

A crucial feature for this option is to determine the level of thick capitalisation. Options might include adopting a group ratio or a fixed ratio, including consideration of a fixed ratio which may be set by reference to capital adequacy requirements as if the company were a regulated financial services business.

This option on the capital ratio to be used based on a pre-determined or group ratio is contrary to the case-by-case analysis required by the arm’s length principle. A “too-low” capital ratio would result in an ineffective measure and a “too-high” capital ratio would lead to excessive taxation and a distortion of the tax due in each jurisdiction.

If this measure were to be applied, it should be based on a capital ratio applicable to the specific circumstances of the taxpayer. However, such approach would result in information requirements and the elaboration of analysis not that different to those used under the arm’s length principle. Under that scenario, this measure would fail as a simplifying measure.

8) Comments on the Minimal functional entity

Option 4: Minimal functional entity

It may be the case in transactions between associated enterprises, especially transactions transferring key business risks or intangibles, that one of the parties to the transaction has minimal functions. Minimal functions
may also be the root cause of an arrangement lacking the fundamental economic attributes that normally underpin arrangements between unrelated parties. It may prove simpler and more effective, therefore, in dealing with such cases to adopt a targeted special measure that focuses on a level of functionality that, where lacking, would cause the profits of that entity to be reallocated.

The option would determine thresholds of functionality. Such thresholds could involve:

- **Qualitative attributes**
  - The entity lacks the functional capacity to create value through exploiting its assets and managing its risks, and is mainly reliant on a framework of arrangements with other group companies in order to exploit its assets and manage its risks.
- **Quantitative attributes**
  - The company in substance performs mainly routine functions, and has a small number of employees;
  - A substantial part of the company's income is from arrangements with group companies
  - The value of the company's assets is greater than or significant in proportion to its income, or an attribute based on a thick capitalization ratio.

The effect of falling beneath the thresholds would require the entity's profits to be reallocated. There are various options that could be considered for doing so:

- A mandatory profit split could be used based on a pre-determined factor. The profits of the minimal functional entity would be combined with the profits of the company or companies providing the relevant functional capacity to exploit the company's assets and manage its risk, and the mandatory profit split applied.
- The profits could be re-allocated to the immediate parent, and if that immediate parent is also a minimal functional entity, iteratively up the chain until the parent is not a minimal functional entity.
- The profits could be re-allocated to the company providing functional capacity, and if more than one such company, shared between them in proportion to the respective contributions.

The quantitative measures proposed are not considered to be appropriate indicators that a Minimal functional entity is in place:
If an entity has routine functions and employees, those factors in themselves should be a proof that the company is entitled to an arm’s length result. If the objective is to demonstrate that the functions or number of employees are not coherent with the level of income involved, then the reasoning would lead to a standard transfer pricing analysis rather than to a special measure.

There does not seem to be a clear reasoning of why the source of the revenue (related or unrelated party) is a factor for determining that a Minimal functional entity is in place.

The comments mentioned for the thick capitalization proposed also apply to the criteria that the value of the company’s assets is greater than or significant to the income. Hence, such criterion would result in arbitrary conclusions or in the elaboration of an analysis not very different from standard transfer pricing techniques.

* * * * *

The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA Branch, and in no case in the name or on behalf of Central IFA or IFA as a whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

Sincerely,

IFA Grupo Mexicano, A.C.
To: Andrew Hickman,
Head of Transfer Pricing Unit,
Centre for Tax Policy and Administration.

(sent via email to TransferPricing@oecd.org)

23rd January 2015

Dear Andrew,

**BEPS Action 8.9 and 10: Revisions to Chapter I of the Transfer Pricing Guidelines**

IHG welcomes the opportunity to submit comments on the above paper ('The Discussion Draft').

IHG is supportive of the BEPS Action Plan in general and of the specific Action 8 to 10 objectives as set out in the introduction to The Discussion Draft. We believe that the draft represents a significant step forward, particularly with respect to matters of analysis and approach, but also with respect to the specific area of risk allocation. As discussed below we do some comments and queries with respect to some aspects of the approach to risk, and feel that some further clarification, or possibly modification, may be required for certain risk areas. We have more substantial comments and concerns in relation to possible special measures. These perhaps have only a peripheral role to play however given the extent of what can be achieved through the application of the extended arm’s length guidance.

**About IHG**

IHG (InterContinental Hotels Group) [LON:IHG, NYSE:IHG (ADRs)] is a global organisation with a broad portfolio of nine hotel brands, including InterContinental® Hotels & Resorts, Hotel Indigo®, Crowne Plaza® Hotels & Resorts, Holiday Inn® Hotels & Resorts, Holiday Inn Express®, Staybridge Suites®, Candlewood Suites®, EVEN™ Hotels and HUALUXE® Hotels and Resorts.

IHG manages IHG® Rewards Club, the world’s first and largest hotel loyalty programme with over 82 million members worldwide. The programme was re-launched in July 2013, offering enhanced benefits for members including free internet across all hotels, globally.

IHG franchises, leases, manages or owns over 4,700 hotels and 697,000 guest rooms in nearly 100 countries, with almost 1,200 hotels in its development pipeline.

InterContinental Hotels Group PLC is the Group’s holding company and is incorporated in Great Britain and registered in England and Wales.

1. **General Comments on the Chapter I revisions and overall approach**
1.1. We welcome the general approach to the update of Chapter I which we consider provides very clear guidance and principles to follow in order to analyse and apply arm’s length principles.

1.2. In relation to section D.1 our only substantive comment or query concerns the example given in paragraph 6. In that respect it seems to us that, in the example as outlined, P is providing both a license to S to use the intellectual property and also providing services to S. The situation described seems to be one of P acting as agent to carry on part or all of S’s business via a vis third parties, and using the intellectual property licensed to S in that context (and not a circumstance of P using its intellectual property to provide services to S). We also note that the final sentence of para 6 talks of S providing services to P rather than vice versa—we premise that is not what the draft intended to say(?). Given our comments in part 4 below, we wonder if the example in paras 90-92, modified so that S2 is stated to be granting an exclusive global license to S1, may provide an alternative example of the point intended to be illustrated by paragraph 6.

1.3. We agree with all of section D.1 and its sub-sections (up to and including paragraph 35) as representing the best practice analytical approach and we welcome the increased clarity and well-structured approach adopted.

1.4. We note in particular the need set out in para 16 to understand how value is generated by the group as a whole. In the context of risk para 42 also makes a distinction between external and internal risk sources—and we wonder if the relevance of external/internal distinctions might be elaborated on more broadly. For example, we understood para 18 to be pointing out that the net risk of the group as a whole may sometimes reflect benefits of internal risk offsets (i.e. natural hedges but perhaps comprising offsetting risks which are in different entities/jurisdictions). We wonder whether it may be worth bringing out this point slightly and cross referencing it to some of the risk/return and group synergy discussions. The issue we have in mind is that if each of the offsetting risk entities are paid an intra-group premium for bearing these risks (or if they pay material intra-group premiums for insuring them) then mismatches can arise i.e. internal costs in individual entities corresponding to an external benefit which is really a group benefit rather than a benefit of any individual entity. This presumably isn’t the intention?

1.5. Whereas we welcome the clarity of analytical process in Section D.1 we have a concern (from question 7 of the framework of questions for special measures) that there is not yet similar clarity with respect to the sequence and relationship between arm’s length analysis and consideration of special measures. For international guidelines and agreements to provide a possibility of a unique agreed outcome they must not set out a unique analytical sequence—otherwise there are no criteria available for choosing between two answers arrived at by alternative sequences.

1.6. In our view the right sequence is to first go through the arm’s length approach and then consider whether or not there is a need to consider special measures. This sequence is consistent with the OECD’s expressed view that the arm’s length approach remains the primary pricing methodology and that the purpose of special measures is to address areas where it is considered that they may give an incomplete or unsatisfactory analysis. Our understanding is that issues associated with the allocation of risk and capital are seen as potentially such areas because (arguably) they are areas where taxpayers can set the parameters within which arm’s length principles are applied, rather than these allocations themselves being determined in accordance with arm’s length principles.

1.7. Finally, we query whether additional commentary may be helpful, perhaps in section D.1.1, to help give clarity as to how to deal with temporal issues, for example where licensing and sub-
licensing of intangibles is concerned. In that context past functional activities, which have built up a platform of IP which is then sub-licensed and taken further in a particular jurisdiction, may be as relevant in considering the nature of the transaction and the appropriate royalty rate as the balance of current functional responsibilities and relationships. We believe that there is a valid concern that a focus solely on current functional responsibilities and relationships may not only lead to a mispricing of current transactions but also to a corresponding lack of consistency when considering capital values and capital disposals.

2. Risk

2.1. We say 'arguably' in 1.6. because we understand the update of Chapter I aims to set out arm's length principles which could be applied to determine where risk should be allocated.

2.2. Whereas we can understand the justification for aligning risk with where the relevant risk is controlled in some circumstances (and indeed we believe that the approach suggested is the current best practise approach in those circumstances) we believe it possibly gives incongruous results in some others.

2.3. One area where greater clarity might perhaps be provided concerns the relevance and appropriate approach with respect to parent company (ie. group-wide) controls over risk. Thus, as para 56 outlines, there will typically be group-wide policies to help manage and control risk, including Delegation of Authority or similar procedures which will require that items which are material in a group context have appropriate oversight rather than risk management being left entirely with the entity directly affected. Whereas para 56 notes the existence of these types of procedures, there does not appear to be commentary concerning their relevance in a pricing context. In particular do they affect the allocation of return from risk (eg. driving service income or similar returns to the parent because they do provide a risk management benefit to the subsidiary) or are they effectively set on one side as functions associated with protecting the investments of the parent?

2.4. Another area where greater clarity might be useful is the extent or circumstances in which some risk aspects do rest with ownership in circumstances similar to those in para 63. Thus whereas that para concerns equipment, a similar circumstance may concern property rented within a group. In that circumstance the risk of capital diminution or appreciation in the value of the landlord’s interest presumably does rest with the landlord –and perhaps requires consideration under principles governing allocation of capital.

3. Interpretation and Non-recognition (D3 and D4)

3.1. We welcome the approach in D.3. And D.4. of considering the fundamental economic attributes of arrangements and the associated conclusion that a non-recognition outcome should be exceptional. As noted non-recognition is by its nature both contentious and a source of double-taxation. It requires the initial and continuing assumption of a form of parallel universe-which will quickly become indeterminable.

3.2. Our conjecture is that a transaction can only truly lack the fundamental economic attributes of arrangements between unrelated parties if it involves a pre-tax cost from a group perspective (ie. even after taking into account qualitative commercial benefits from a group perspective, it is only tax benefits which give it a positive NPV). If a transaction has a neutral or positive pre-tax NPV and it appears to lack the necessary economic attributes for the parties involved then that would suggest that there is a further group entity who is obtaining some form of benefit for
which it is not paying. Where possible it is likely to be preferable to identify and impute a charge to such an entity rather than arrive at a position of non-recognition.

4. The Examples in Paras 90-92

4.1. The difficulty with preparing and commenting on examples used for transfer pricing purposes is that the appropriate conclusions can be very dependent on the precise facts. An associated danger of the simplification necessary for such examples is that it can produce or reinforce assumptions, which may be inaccurate, concerning the underlying subject matter—in this case intangibles. As intangibles are a core area of our business we therefore wish make a few preliminary comments and caveats concerning these aspects of the example. The key comment however is that intangibles which have the same name (in this case ‘trademarks’) may have very different profiles.

4.2. The example states that S2 has ‘no capability to exploit the trademark’. We note however that licensing a trademark is an exploitation of a trademark. For example we suggest that if S1 were to license a third party to use the trademark there would be no question that that involves an exploitation of the trademark by S1.

4.3. The next question or comment concerns what functions are core to the exploitation of a trademark by way of licensing it. That is probably dependent on the particular subject matter. Certainly where what is being licensed is a trademark associated with a business format and brand concept, as for IHG, that will involve many different functions and a large headcount in order to perform continuous processes of standards maintenance, update and enforcement across all operating areas so that hotels deliver consistent quality, which is in tune with the brand concept and with the tastes and technology of the time and location. Possibly, for product trademarks, the required numbers and functions are far fewer but, even then, ‘several employees’—even ones who manage to spend $10m—sounds very few.

4.4. With respect to marketing there is perhaps also a question as to whether the marketing concerned is of the product carrying the trademark (i.e. primarily driving product sales) or of the trademark per se—but in either case it would be expected that S2 would have some direct or indirect control to ensure that there was consistency with the intended positioning of the trademark.

4.5. Perhaps a critical factual aspect which should be commented on in the example is whether or not the license granted by S2 to S1 is exclusive or not.

4.6. Based on the facts described—and consistently with the comments earlier in our submission—we would agree that if the transaction carries a negative pre-tax NPV (which the question suggests) then it is likely to lack the economic attributes of arrangements between unrelated parties. Whether that is as a result of the position of S1 or the position of S2 would depend on the price paid by S2 and the level of royalty payable by S1. It is also possible to conceive of circumstances however where that may not be the case [e.g. if the pricing was positive for S1 and comparative legal systems or other comparative advantages of the location meant that S2 was better placed to exploit the trademark more broadly via licensing].

4.7. We would suggest however that the example would merit careful analysis following the principles set out in section D.1. of The Discussion Draft. It seems quite possible based on the facts [particularly if S1 is granted an exclusive global license] that the real transaction is not a sale and license back at all but a sale of a share of future profits for a capital sum. There are various aspects of the example which suggests that the trademark may be an almost irrelevant
appendage rather than the real subject matter of the transaction. That interpretation may of course have broader tax relevance than just transfer pricing.

5. Moral Hazard

5.1. We believe that there are a variety of factors which provide similar incentives, controls and protections against moral hazard within a group context to those which apply in a third party situation. Thus whereas there clearly are some distinctions in this area from a pure arm’s length situation we do not believe that those are significant enough to merit a deviation from a similar arm’s length comparable.

5.2. The primary factor is the existence of allocated management accountabilities and associated management performance measurements. This creates an incentive (where not controlled or constrained) for individuals or departments to benefit in budgetary and evaluation terms, even where that is at the cost of an adverse impact elsewhere in the organisation. That is of course a dysfunctional feature within an organisation and so ways of working and other controls are put in place to try and discourage such behaviour. That creates a position which broadly parallels an arm’s length situation both in terms of the base position of potentially divergent interests and in terms of the existence of counteracting controls to try and protect against that.

5.3. At an entity level board directors will also typically have legal obligations to consider issues of corporate benefit for that individual entity. That also provides an incentive, or indeed requirement, to act in an arm’s length fashion-and ensure others do.

5.4. With respect to the example given in paras 90 to 92 (and commented on above), it is not clear to us that, in the narrow example given, there is the divergence of interest between S2 and S1 necessary to create moral hazard. This is not because of any group relationship however but because of the narrowness of the license arrangement. A divergence of interest could arise if S2 was entitled to license the trademark more broadly but we suggest that the factors above act to mitigate any moral hazard related differences from arm’s length circumstances.

6. Risk-return trade-off

6.1. We are not clear of the extent of the limitations intended by the phrase ‘sole effect is to shift risk’. If, taking into account the functional and broader profile of the transacting parties, a transaction whose sole effect is to shift risk, carries the fundamental economic attributes of arrangements between unrelated parties then it should in principle be recognised. We note however that that economic attributes test does place a significant constraint on such transfers because it does not allow them to be arbitrarily separated from the functions and factors relevant to their management-and our understanding is that that is what is necessary to address BEPS.

6.2. With respect to questions concerning the example at paras 90-92 we refer to our comments above. As commented there it seems to us that the substance of that transaction may well be something similar to the acquisition of a partnership interest and it should be evaluated accordingly.

6.3. We believe that the risk-return trade-off is an arm’s length principle which should apply in general to transactions involving, as part of their aspect, the shifting of risk. We believe that the principles outlined in The Discussion Draft are appropriate principles to guide decisions as to where risk is properly allocated within groups and thus help to counter BEPS. As noted above
we believe that there remain some areas where further clarification may be needed.

6.4. We note in particular our comments in 1.4 concerning risks where there is a natural intra-group hedge. A variation of this type of issue perhaps also arises where groups decide to bear and self-insure a layer of risk. Each of these categories of action meet genuine commercial needs and thus should be facilitated, but they may each give rise to undesirable risk based distortions of profit allocations within a group (or perhaps BEPS). We suggest that consideration is given to whether, in accordance with group synergy principles, best practice methodologies might be developed to enable natural hedges to be offset within a group, and costs of self-insurance shared, with just an administration based return rather than a risk based return for the internal insurer. This is however a specialist area and consideration may need to be given as to whether there are any non-tax (e.g. regulatory) obstacles to such approaches.

7. Potential Special Measures-General Comments

7.1. We highlight our comments in 1.5 and 1.6 above concerning the need to ensure that there is a unique agreed analysis sequence in order to give a prospect of resolving any disagreements or uncertainty and arriving at a unique agreed answer. Expressed in an alternate way, in order to comply, taxpayers need to know what the rules are which they need to comply with.

7.2. For this reason we have expressed the view that normal arm’s length rules should be applied first and then special measures used to address a specified and clearly defined range of circumstance which it is considered that transfer pricing rules are, for one reason or another, not capable of addressing satisfactorily.

7.3. We note in this context that para 6 of Part II states that it is not critical at this stage to determine whether particular measures are within or beyond the arm’s length principle. For the reasons given above we suggest that it is critical to determine a unique analysis sequence and clear criteria as to where and in what circumstances special measures fit into that sequence. That may require determination as to whether or not a measure is within or beyond the arm’s length principle.

7.4. For example, if the conclusion is that special measures will always require the use of contingent payment mechanisms for certain categories of intangibles, then taxpayers are likely to prefer to draft contracts to include such clauses, but including symmetrical clauses so as to minimise the risk of one sided adjustments and double taxation. If such contingent payment approaches are considered to be arm’s length then so are such drafting approaches. If the approaches are beyond arm’s length approaches then they need to specifically accommodate such symmetrical approaches.

7.5. Para 3 of Part II identifies the residual BEPS risks which special measures are intended to address as mainly relating to information asymmetries between taxpayers and tax administrations and the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities’. In our view any special measures which extend to any significant degree beyond this scope would require clear additional justification as to their purpose and rationale. Prima facie their effect would be to impact non BEPS arm’s length transactions in a way which would misalign taxing rights to a position not consistent with value creation.

8. Option 1 Hard-to-value intangibles (‘HTVI’)

8.1. As discussed in 7.4 consideration may need to be given to whether or where the option 1
approach would represent an arm's length approach. As a general comment, in approaching 25 years of experience in an intangibles focussed business, including numerous third party transactions for the direct or indirect acquisition or disposal of intangibles, the author of this submission cannot recall a single example of a clause requiring contingent payments with respect to the core underlying intangibles (as opposed to in relation to narrower and limited, well defined short term uncertainties).

8.2. One primary reason for that is of course that a vendor wants to ensure that post transaction downside risks are for the account of the purchaser, and correspondingly the purchaser wants to ensure it benefits from favourable post transaction events. Events which have a material unexpected impact do after all occur—for example a 9/11 type event or a major epidemic, or developments such as the fall of the Berlin wall or the dramatic opening up and growth of China.

8.3. A related reason which is perhaps of significance in our business, and may give problems with applying Option 1 type rules, is that the subject matter intangibles are, as described in 4.3 above, not static but are subject to processes of continuous creation and development. Thus rules which are intended to compare post transaction results for version 1 intangibles to forecasts for version 1 intangibles, actually end up comparing version 1 forecasts to results for versions 2, 3, 4 and 5 (plus perhaps branches out into new brands). There are significant difficulties in comparing like with like.

8.4. A key issue is defining the purpose and scope of option 1. If its purpose is a broad one of dealing with information asymmetries by always permitting tax authorities to use such an approach then our comments in 7.4 apply—ie. it is not an avoidance or equivalent measure and it would need to be applied generally on an asymmetric basis. If it is a much narrower measure to help tax authorities deal with circumstances where taxpayers have not properly documented and sourced their underlying valuation analysis and associated forecasts then it perhaps seems better targeted and appropriate, although we note that measurement issues such as those described in 8.3 may remain.

8.5. The critical threshold phrase in option 1 therefore seems to be ‘where the taxpayer...does not contemporaneously document those projections and make them available to the tax administration’ and this needs expanding upon. For example, our understanding is that if there is valuation work done, properly documented and based on forecasts which are used for more general corporate purposes, then the provision would not apply. Any debate in that circumstance would then concern the appropriateness of any additional adjustments or assumptions needed to modify general corporate forecasts for this more specific valuation purpose.

8.6. Set in this context, and with appropriate supporting guidance, the measure would therefore act as an incentive to taxpayers to ensure that transactions were appropriately documented and supported, and a tax authority protection, with perhaps a deterrent element, where they were not.

9. **Option 2: Independent Investor**

9.1. We believe this option is unlikely to be either practical or capable of being drafted in a way which gives a single clear sequence for determination. That is firstly because we doubt that circumstances will be as simple as in the outline, and secondly because as outlined we believe a variety of alternative conclusions could be arrived at—even on simple facts let alone more complex ones.
9.2. With respect to our first point the option seems to assume that in such circumstances there will always be a single company which the asset rich company depends on for its return rather than multiple companies. It also perhaps assumes that the asset rich company has a single purpose and activity rather than multiple activities. It seems to us that this option will break down and become unworkable as soon as more complex circumstances are considered.

9.3. With respect to our second point it seems to us that there may be a variety of options which a rationale investor could consider. For example it could decide to acquire the capital asset itself rather than invest in either entity. Or, depending on the broader surrounding facts, it may quite rationally choose to invest in either the ‘capital rich’ company or some similar company — this may for example be rational if the jurisdiction where the functions sat had capital controls or other legislation which would mean the investor would be uncertain of being able to recover or protect its capital there.

9.4. We therefore do not think it is likely that this option can provide the basis of a workable solution.

10. **Option 3: Thick Capitalisation**

10.1. We are unclear as to how it is proposed to target and apply this option. It would seem excessive and impractical to apply it across all group companies. By its nature, for example, a thick capitalisation approach requires current valuations of any company to which it is applied (or which is used as a comparable) in order to obtain an appropriate measure of Balance Sheet capital ratios. Even then a comparable will only be appropriate if it concerns a comparable business and group companies will not all conduct common businesses.

10.2. More generally similar issues apply to those relevant when considering proposals for full interest allocation under Action 4. Whereas in some jurisdictions and for some entity fact patterns, there may be a degree of freedom concerning capital structures, companies do not have an unfettered ability to set capital structures in ratios of their choosing. They certainly do not have the practical ability to flex those ratios across all entities on a year by year basis as the underlying financial position and facts change.

10.3. To take one example a number of countries have exchange controls or regulatory provisions which prevent, or severely restrict, the ability to introduce debt into companies. Other restrictions include corporate law restrictions on the introduction of debt where there are insufficient relevant reserves recognised in accounting terms (which will frequently arise where material assets are carried at a historic cost figure which is significant less than current market value).

10.4. To the extent that thick capitalisation principles could be applied on a more limited basis to targeted entities we question whether they would meet their intended objectives. Thick capitalisation provisions will reattribute only a proportion of the returns from capital whereas, for objectionable entities, we understand the objections to apply to all of their returns and not part of them.

11. **Option 4: Minimal functional entity**

11.1. We note that this option is drafted much more broadly than to just deal with the issues of informational asymmetry and capital allocation which are identified in para 3 of Part II as the main residual risk areas for special measures to address. In our view the option’s scope is unnecessarily broad, extending to issues which can be, and are, addressed by arm’s length
provisions set out elsewhere (e.g. in Chapter I and Chapter VI as updated). We do however consider that the option, in more limited form, might provide a framework for considering issues of allocation of capital.

11.2. We understand that the option would not apply to service activities, however limited, but this should be made clear. Firstly the allocation of returns from service activities is fully considered and capable of being dealt with under arm’s length transfer pricing principles. Secondly, where the level of activity in a jurisdiction is small but is sufficient to create a taxable presence (i.e. via a permanent establishment) groups will often prefer to recognise and capture that presence in the form of a legal entity- because that form is better understood and easier to deal with from a tax and non-tax compliance perspective.

11.3. The introduction to the option refers to transfers of business risks or intangibles to minimal functional entities. We note however that the main body of the updated Chapter I guidance addresses and casts doubt on whether business risks would be allocable to minimal functional entities in any case under arm’s length principles, and also casts doubt (in the examples in paras 90-92 and more generally in the updates to Chapter VI) concerning the extent to which intangible returns can properly be allocated to a company which does not have the capacity to conduct the functions central to the maintenance, protection and exploitation of those intangibles.

11.4. As noted in discussion of the examples in paras 90-92 it is doubtful, for most categories of intangibles, whether a minimal functional company can conduct those functions. It is conceivable however that there may be categories of intangibles which generate something approaching pure income profit and where a minimal functional entity could be entitled to such profits without normal arm’s length principles leading to a reallocation of profits—because the profits effectively derive from capital investment and not current functions.

11.5. The same principles apply to purer investments of capital via loans or similar activities- in these cases there are typically fairly minimal people functions necessary to manage and make such loan investments. If sufficient functional capacity is not present however then reallocation or other adjustment may be appropriate.

11.6. In our view there are two routes for dealing with this type of situation—either by disallowance of the corresponding expense (which we suspect is the right answer in the para 90-92 type example given our analysis of it) or by a reallocation of profits. If there is no disallowance then we see no basis for reallocating profits from capital returns to an entity other than the parent – under CFC rules.

11.7. We note that our understanding is that, within the EU, the ability to apply CFC (or equivalent) rules is constrained by the Cadbury principles. This is reflected in our comments in 11.4 and 11.5—i.e. if what is concerned are genuine economic activities, which the entity is able to genuinely conduct with a limited functional capacity, and that is genuinely conducted in an EU jurisdiction, then an EU parent is unlikely to be able to apply CFC rules to such income.

12. Option 5: Ensuring appropriate taxation of excess returns

12.1. As described in The Discussion Draft the trigger for applying this option is simply a low rate of tax. We do not consider that that is an appropriate basis to apply without any consideration of the level and sufficiency of the functions in the entity. It is the sovereign entitlement of countries to set their tax rate at levels which they consider appropriate and, provided that that rate is then applied to profits which are properly attributable to the jurisdiction on a value creation basis, and
not selectively in a way which represents State Aid or a Harmful Tax Practise, that is not in itself an indication of BEPS.

12.2. As discussed above, for that reason, it is unlikely that such an approach would be consistent with EU law.

12.3. As noted in The Discussion Draft there also remains a central need to define excess returns. The outline described is unreasonable and unworkable. For example, the option implicitly treats all related party service provision as objectionable. There is nothing objectionable about intra-group service provision.

12.4. The option also treats all income from intangibles as objectionable per se. It is not. Much, or perhaps most, income from modern intangibles is essentially part of active income. Most classes of modern intangibles play a role similar to plant and machinery in a more traditional business.

12.5. We do not believe that this option is capable of being developed into an appropriately targeted or more generally acceptable form.

We hope that these comments are of constructive assistance to the OECD’s considerations. We would be pleased to expand on them further as necessary.

Yours faithfully,

C.P. Garwood
Head of Tax
BEPS Actions 8, 9 and 10: Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures)

Comments by the Insurance Company Working Group on BEPS

Introduction

These comments are being submitted to the OECD by the Insurance Company Working Group on Base Erosion and Profit Shifting (BEPS),¹ a group of global insurance and reinsurance companies, in response to the OECD’s paper of 18 December 2014 entitled “BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to the Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures).”

We welcome the recognition in the Discussion Draft that risk and capital are core components of financial services businesses and that different guidance may therefore be needed for financial services (specifically mentioned in Question 8 in the “Additional Points” box in paragraph 40 on page 15 of the Discussion Draft and Question 9 in the “Framework for questions on all options” box in the Special Measures section on page 40 of the Discussion Draft). We will address these questions and also identify particular aspects of the Discussion Draft that give rise to concerns for our members.

The need for separate guidance in Chapter I for insurance

We believe it is necessary to differentiate the insurance industry in Chapter I, Part D of the Transfer Pricing Guidelines because the proposed guidance in the Discussion Draft is not relevant or meaningful to the insurance industry. We therefore propose that the existing Article 7 guidance be applied in Chapter I for groups carrying out insurance activities. The following discussion is intended to provide background supporting this proposal.

Unique among businesses, the insurance business consists of accepting risks of unrelated parties (i.e., policyholders) related to possible events outside the control of both the policyholder and the insurer. In addition, the insurance business must be conducted in accordance with country-specific regulations regarding the amount of capital the insurer must maintain in order to fund potential obligations to policyholders.

The OECD has already spent considerable time and effort to understand the functions, assets, risk and value chain of the insurance industry in developing bespoke guidance for the allocation

¹ The members of the Working Group are AIA Group Limited; American International Group, Inc.; MetLife, Inc.; Prudential Financial Inc.; Prudential plc; Swiss Reinsurance Company Limited, and XL Group plc
of risk and capital within insurance groups. The OECD had extensive discussions with the industry during the development of guidance on Article 7 of the OECD Model and preparation of the OECD Part IV\(^2\) report. This applies the separate legal entity approach in order to allocate capital to the respective parts of an insurance group by reference to people functions. OECD Part IV, and its subsequent adoption into domestic laws and tax treaties, is widely regarded by both tax authorities and insurers as a reasonable and fair approach to taxing insurers.

As discussed in detail in Part IV, the operational functions of an insurance company are the functions that must be performed in order for an insurance enterprise to assume insured risks. An insurance business has one Key Entrepreneurial Risk Taking (“KERT”) function and this is the ‘Underwriting/risk assumption’ function. It is the KERT function that drives profitability of the insurance group.\(^3\) The KERT function is so critical to the business that it cannot be outsourced.

‘Underwriting/risk assumption’ activities are the most important in the decision to accept insurance risk.\(^4\) This has five components including setting the underwriting policy and risk selection, which involve assessing the group’s appetite for the risk by reference to the existing investment portfolio and overall capacity limits. Another key component is risk retention analysis, which is the decision-making regarding whether to retain the risk or reinsure it in order to lay off the risk assumed.\(^5\) Reinsurance is also identified as being ‘of central importance’ to the risk management process\(^6\) through the pooling of risk.

There is a detailed description of risks in the context of insurance businesses,\(^7\) including a discussion of moral hazard, in OECD Part IV.

For insurers, it is not possible to separate risk acceptance (an insurer’s ‘product’) and capital (an insurer’s ‘plant and machinery’). An insurance entity that underwrites risk requires capital in order to do so. This is akin to the plant and machinery which produces a manufacturer’s core product needing to be in the same location as the product being produced. In industries other than the regulated financial services industries, there is not necessarily a correlation between the location of risk and capital within an MNE group, i.e. there may be risk in an entity but not capital, and vice versa. However, for insurance companies, risk acceptance, substance and capital must go hand in hand, as capital is the means by which risk can be assumed under applicable regulations. This is recognized in paragraph 66 of the Discussion Draft (“MNE groups, unless subject to capital adequacy regulations, can determine the capital structure of subsidiaries without explicit consideration of actual risk in that subsidiary.”)

Notably, the analysis of insurance in OECD Part IV includes a thorough discussion of the role of capital and capital management. This analysis is relevant to the Discussion Draft. Capital is actively managed in insurance groups to ensure:

---


\(^3\) OECD Part IV, paragraphs 69, 94.

\(^4\) OECD Part IV, paragraphs 94, 34, 69.

\(^5\) OECD Part IV, paragraph 34.

\(^6\) OECD Part IV, paragraph 40.

\(^7\) OECD Part IV, paragraphs 55-63
Adequate capitalization of all insurance subsidiaries and branches, to ensure that liabilities to policyholders can be met, both in the present day and on the basis of actuarially modelled future loss scenarios; 

Matching of liabilities with appropriate asset classes of similar term to minimize liquidity risk; 

Maximizing the return on that capital; and 

Minimizing the cost of any capital raised (the form and proportions of capital which can be held by an insurance company are subject to strict regulation and therefore insurers have significantly less freedom to access efficient capital than non-insurance groups).

Because regulators simply do not allow risk to be borne in an insurance company unless it has the appropriate capital and people functions, the arm’s length principle will cause income to be allocated for tax purposes to the appropriate entity within an insurance group.

In summary, appropriate differentiation of the insurance industry in Chapter 1, Part D of the Transfer Pricing Guidelines would ensure consistency with existing guidance applying the separate enterprise approach for permanent establishments, as was done in OECD Part IV, where general Article 7 guidance was provided in Part I and special analysis of the insurance industry was provided in Part IV. We therefore propose that the existing Article 7 guidance be applied in Chapter I, Part D for groups carrying out insurance activities.

For more information on the insurance business and how it is regulated, see the Appendix.

**Particular aspects of the Discussion Draft of concern to the insurance industry**

To reiterate, an insurance contract is a contract which transfers risk. In order for a contract to be accounted for (and therefore taxed) as a contract of insurance, there needs to be sufficient risk transfer in substance. This is also assessed for regulatory purposes. Specific accounting and regulatory standards apply.

The proposed guidance in Part 1 of the Discussion Draft contains numerous statements that are not appropriate in the context of insurance.

For example, statements about allocation of risk and profit to the party that has more control over the risk (e.g., in paragraphs 38, 39, 60, 61, 72, and 78 of the Discussion Draft) do not distinguish between insured third-party risks (over which no one has control) and business risks of the MNE group of which the contracting parties are members. As noted above, for an insurance or reinsurance group, applicable regulations will impose significant constraints on the ability of group members to allocate risk or capital in a way that is not aligned in substance with income allocation within the group.

More specifically, paragraphs 38 and 39 discuss the need to examine the conduct of related parties to a contract in identifying the actual allocation of risk between them. It is noted that in arm’s length dealings, unrelated parties generally will not agree to take on risks over which they have no control. Control over risk is described as the capability to make the decision to take on
the risk and subsequently to decide whether and how to respond to the risk. It is implied that related parties may contractually allocate risk to a party that does not control the risk, because related parties “lack the divergence of interests” that exists between unrelated parties. Insurance groups can manage their exposure to risks through pricing and by ensuring there is not a concentration of risk exposure to a particular event by writing certain risks up to a specific exposure limit or through reinsurance, but once the risk is assumed the insurer has no control over whether a loss event occurs in relation to that risk. In practice, the reinsurer will have its own operating capabilities and be subject to detailed regulatory rules, and hence will actively ensure there is management of the risk transferred to it via intra-group reinsurance treaties.

Furthermore for insurance groups, including in the context of related party reinsurance, this discussion is not relevant, because regulators require a licensed re/insurer to have the independent capacity to perform the underwriting function discussed above.

Similarly, paragraphs 60 and 61 discuss allocating risk between related parties on the basis of the parties’ conduct, rather than on the basis of the contract between the parties. For the reason noted above in relation to paragraphs 38 and 39, it is not possible to have a divergence between the parties’ conduct and their contract in the case of related party reinsurance within an insurance group. Paragraph 61 rightly contains an illustration of this point, by giving the example of car insurance purchased from an unrelated insurer and correctly stating that “the insurance company will have the relevant capabilities to assess, underwrite and manage the insurance risk.”

Paragraph 72 concludes this section of the Discussion Draft as follows: “Circumstances meriting particular scrutiny include those where the transferee has no risk management capability, and those where risk management is performed by the transferor.” Again, in the context of an insurance group, such circumstances cannot arise with respect to the transfer of risks to an affiliated reinsurer. OECD Part IV includes a detailed discussion of risk management and highlights the importance of the risk management function for reinsurance businesses.

Apart from the risk management issue, we note that paragraph 18 of the Discussion Draft is problematic from the insurance industry's perspective. It mentions intra-group insurance in support of the proposition that a “controlled arrangement may require reduced capabilities to what might typically be required in uncontrolled transactions,” stating that the group already benefits from the diversification of assets and risks that exists in the group as a whole. This does not accurately reflect the reality of intra-group reinsurance within an insurance MNE, where both the cedant and the reinsurer will be subject to regulations that require them to price their transactions and maintain capital as if each were a standalone company and not part of a group. To avoid confusion, we recommend that this paragraph be revised so that it uses an example other than intra-group insurance.

**Examining “ex-ante and ex-post prices”**

In several paragraphs, the Discussion Draft supports an ex-ante and ex-post examination of pricing and resulting profits, noting that a party may not be entitled to “unanticipated profits,” as

---

8 OECD Part IV, paragraphs 38-41
9 OECD Part IV, paragraph 34
mentioned in paragraph 78, because it does not control risk and will not be allocated risk. The 
non-recognition section of the Draft also contemplates such an analysis. This analysis is 
problematic in the insurance context, as it suggests that transfer pricing adjustments can properly 
be made on an ex-post basis “to take into account the difference between the expected outcome 
and the actual outcome,” and that the control of risks is relevant to such adjustments. This 
approach is not appropriate in relation to related party insurance or reinsurance, because no one 
can control insured risks, and therefore a reinsurance contract could result in either a profit or a 
loss for the reinsurer, depending on whether insured losses occur. This is heightened in the case 
of reinsurance of low frequency, high severity risks (e.g., earthquake damage).

Moreover, a retrospective transfer pricing adjustment resulting in a significant unexpected tax 
liability could negatively affect an insurer’s capital position, with further negative consequences 
for the insurer and its policyholders.

For all of these reasons we believe that related-party reinsurance should not be covered by 
general guidance permitting ex-post examination of pricing and resulting profits.

**Comments on D.4 Non-recognition**

The discussion of non-recognition in paragraphs 83 through 93 of the Discussion Draft maintains 
that tax administrators may consider non-recognition because the arm’s length standard when 
applied to certain taxpayer arrangements discussed in the Draft is not applicable from a pricing 
perspective because the transactions do not have arm’s length attributes. The Draft explains that 
this phenomena is due to the fact that, as explained in paragraph 86, “Except in certain regulated 
sectors, MNE groups have freedom to control their structures, including shareholding, 
capitalization, and legal form.” The Working Group recommends that the circumstances 
inherent to regulated insurance groups, and the implication that non-recognition is not relevant 
for such groups, be stated more plainly. As is recognized in OECD Part IV (at paragraphs 18 
and 178 of Part IV), “reinsurance plays an important role in the efficient functioning of insurance 
markets” and “insurance companies commonly buy reinsurance from both unrelated and related 
reinsurance companies.”

Paragraph 89 of the Discussion Draft also contains conclusions and recommendations that are 
not relevant in the insurance context. This paragraph, which deals with whether a transaction 
exhibits the fundamental economic attributes of arrangements between unrelated parties, states: 
“it is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a 
pre-tax basis.” This does not reflect the regulation of insurance and reinsurance companies at the 
operating entity level, and implies a retrospective test of the validity of intragroup transactions. 
In the case of related party reinsurance, the agreement is priced prospectively, using actuarial 
modeling of likely outcomes and other relevant analytical factors but, as noted, above, the 
ultimate risk that an insured event will happen is beyond the control of the taxpayer.

In other words, due to regulation, insurance groups do not have the freedom to structure their 
arrangements in the ways described in paragraphs 85 through 87 of the Discussion Draft. 
Consequently, the analysis in paragraphs 88 through 92 of the Discussion Draft is not 
appropriate for related-party reinsurance within an insurance group.
Potential special measures

Regarding Part 2 of the Discussion Draft, which describes potential special measures for addressing residual BEPS risks in connection with intangible assets, risk, and over-capitalization, we are concerned that any tax rule that is inconsistent with the arm’s length principle may have adverse unintended consequences for the insurance industry. Specifically, in response to Question 9 on page 40 of the Discussion Draft, we recommend that the insurance industry be excluded from the special measures, for the reasons discussed below.

Insurance regulations generally require business substance and value creation to be aligned with income in an insurance group. In contrast to this, paragraph 3 on page 38 of the Discussion Draft mentions “the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities,” referred to in the Draft as “MFEs.” This does not apply to insurance groups, which must allocate their capital to the operating companies in the group that underwrite insurance risk and employ staff who are qualified to perform the KERT function of underwriting.

Option 1 would permit tax authorities to presume the existence of a price adjustment mechanism in a related-party sale of a hard-to-value intangible. Given that intangibles are not a significant factor in the business of insurance, Option 1 appears to have little relevance for our industry.

Options 2 and 3 address “Inappropriate returns for providing capital.” Option 2 is aimed at situations in which a company owns assets that are managed by a related company. Under this option, the income from the assets would be allocated for tax purposes to either the management company or the parent company of the group. Option 3 is conceptually similar: it targets companies with “excess capital” and would allocate the income attributable to such capital to the shareholder who invested it by deeming the investment to be an interest-bearing loan.

Options 2 and 3 describe fact patterns that generally would not exist in an insurance group, due to sophisticated actuarial pricing models, regulatory requirements, rating agency considerations, and the business incentive to manage capital efficiently so that it supports as much underwriting business as possible. However, in the absence of more detail regarding these options, we cannot be certain that they would not produce inappropriate results if applied by tax authorities in the context of an insurance business. A measure based on a fixed ratio or other formulary approach would not take into consideration the different levels of capital required to be held, depending on the types of risk written. For example, high frequency/low severity risks (e.g., consumer auto insurance) may not require much additional capital to be held whereas low frequency/high severity risks (e.g., property catastrophe loss insurance) may require substantial capital buffers.

Option 4 would reallocate all of the profits of an entity that has minimal functions. As in Options 2 and 3, the reallocation would be either to related parties who are managing the relevant assets or to the shareholder who provided the assets to the minimally functional entity. Option 4 appears to have little relevance to MNE insurance groups because it is premised on the existence of significant profits in a minimally functional entity, which is unlikely to occur in insurance groups due to the factors discussed earlier. However, insurance companies, particularly reinsurance companies, operate with very low headcounts compared to other
industries because the KERT function of underwriting can be performed by a small number of qualified employees. This gives rise to a concern that Option 4 might be misapplied in the insurance context.

Also, insurance companies are commonly subject to regulations that effectively require group services, including risk management, treasury, governance, and setting of underwriting standards, to be housed in an unregulated affiliate that deals only with affiliated entities. Due to cost efficiencies, certain routine functions may be outsourced to affiliates in developing countries. Such affiliates would normally earn only a small profit margin under the arm’s length principle, so it is difficult to see any BEPS problem that would justify applying a special measure in these circumstances.

Option 5 would reallocate so-called excess returns that are subject to a low effective tax rate to the group parent company under controlled foreign company rules. Excess returns would consist of profits associated with intangibles and risk, with an exception for profits representing “normal returns on capital invested in real activities within a jurisdiction” and “local income from sales or services to unrelated persons” in the company’s country of residence. This appears to be similar to certain U.S. tax proposals in recent years, including a proposal in President Obama’s FY 2016 budget relating to international tax reform, and a proposal to impose a U.S. minimum tax on certain foreign source earnings relating to the exploitation of intangibles in tax reform legislation introduced in 2014 by then U.S. House of Representatives Ways and Means Committee Chairman Dave Camp. We have a number of concerns about this potential special measure:

- If the definition of excess returns is focused on returns from intangibles, the formula for isolating these returns would need to be carefully designed. For example, then-Chairman Camp’s proposal, noted above, determined intangibles income to be all income not related to tangible property. For service industries, including the financial services industry, any test of “normal” returns based on investment in tangible business assets would be inappropriate because most of the income produced by the business would relate to non-tangible assets, including people functions.
- Similarly, the definition of an “allowance for corporate equity” that includes a risk-free rate of return on equity invested in active assets, as included in President Obama’s most recent international tax reform plan, would need to recognize that capital invested in real activities can take forms other than tangible capital assets such as machinery and equipment.
- Further, a test based on whether the CFC’s customers are located in the CFC’s country of tax residence would be difficult to apply in regions such as Europe, where the Freedom of Services directive facilitates and encourages regional, cross-border activity within the EU countries.

The secondary rule mentioned at the end of the description of Option 5 needs to be outlined in more detail. Allocating the CFC’s excess returns “to other jurisdictions based on a pre-determined rule” is too vague to comment on at this time.
We also note that Option 5 appears to be more appropriate for consideration by the OECD in connection with its work on strengthening controlled foreign corporation regimes, as opposed to inclusion in the Discussion Draft (which relates to transfer pricing).

Overall, we are concerned that the special measures options would depart from existing OECD guidance on the application of the arm’s length principle to transactions within MNEs. For insurance groups in particular, the OECD Part IV guidance already allows tax authorities to look at economic substance (i.e., the performance of the KERT function) in determining appropriate transfer pricing results. In addition, the domestic tax laws of many countries include a general anti-avoidance rule that deals with the BEPS issues targeted by the special measures options in the Discussion Draft. Therefore we recommend that these options be revised so as to target potential BEPS issues that are not otherwise addressed already in OECD transfer pricing guidance or the domestic tax laws of OECD/G20 member countries.

The members of our Working Group would be happy to work with the OECD on evaluating any residual BEPS risks that are identified in the insurance sector and on developing appropriately targeted special measures if necessary.
Appendix

The value chain of an insurance group, as set out in OECD Part IV, is below:

The operational functions of an insurance company are the functions that must be performed in order for an insurance enterprise to assume insured risks.

An insurance business has one Key Entrepreneurial Risk Taking (“KERT”) function and this is the ‘Underwriting/risk assumption’ function. It is the KERT function that drives profitability of the insurance group. The KERT function is so critical to the business that it cannot be outsourced.

‘Underwriting/risk assumption’ activities, as shown in the diagram above, are the most important in the decision to accept insurance risk. This has five components including setting the underwriting policy and risk selection, which involve assessing the group’s appetite for the risk by reference to the existing investment portfolio and overall capacity limits. Another key component is risk retention analysis, which is the decision-making regarding whether to retain the risk or reinsure it in order to lay off the risk assumed. Reinsurance is also identified as being ‘of central importance’ to the risk management process through the pooling of risk.

Accordingly, the concept of reinsuring risk, either externally or intra-group, to optimize pricing and drive profitability is a core component of the KERT function and of an insurer’s overall value chain. This value arises from the economies of scale and synergies of combining risks into one large pool.

The new OECD guidelines recently issued under the Action 8 report recognize that local market features, such as requirements to obtain regulatory licenses and synergistic benefits.

---

10 OECD Part IV, Section B-2 (para 23-50).
11 OECD Part IV, paragraphs 69, 94.
12 OECD Part IV, paragraphs 94, 34, 69.
13 OECD Part IV, paragraph 34.
14 OECD Part IV, paragraph 40.
15 OECD (2014), Guidance on Transfer Pricing Aspects of Intangibles, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Action 8, Par. 1.98 which notes that “such group synergies can arise, for example, as a result of combined purchasing power or economies of scale…”
16 OECD Guidance on Transfer Pricing Aspects of Intangibles, 16 September 2014.
17 OECD Guidance on Transfer Pricing Aspects of Intangibles, 16 September 2014, paragraph 1.90 et seq.
from operating as a group as opposed to a stand-alone entity, may provide value for other group affiliates. In the case of an insurance group that pools risk through intra-group reinsurance, this is already addressed through the transfer pricing of intra-group reinsurance arrangements:

- Front-end market pricing inherently takes into account the capital benefit of pooling the risk which benefits the local underwriting entity directly in pricing competitiveness.
- The local underwriting entity will pay an arm’s length premium for the reinsurance (by reference to the third party risks assumed, taking into account the cost of capital) and in return the reinsurer meets the insurer’s liabilities to pay claims. The reinsurance price will also ordinarily include a commission payable by the reinsurer to remunerate the cedant’s costs. These costs typically include acquisition costs such as sales and marketing expenses along with some local regulatory costs.
- Insurance risk is borne by the reinsurer and therefore capital is deployed by the reinsurer. The local underwriting entity is relieved of this capital requirement.
- Under existing transfer pricing principles, the commercial rationale for the reinsurance should be documented and this is typically by reference to the drivers noted above.
- A large, geographically diverse pool of risk may optimize the group’s ability to procure a more favorable external reinsurance price than small, locally concentrated portfolios on a stand-alone basis. At the same time, this reduces costs of administration. Again, these synergies should be reflected in the intra-group reinsurance pricing. Furthermore, typically a central reinsurance function within an insurance group would operate under a Service Level Agreement and be remunerated at arm’s length.

Because a reinsurer is more broadly diversified than a primary insurer, the reinsurer does not need to hold as much capital to cover the same risk as an insurer. The difference between the insurer’s and reinsurer’s capital needs for the same risk is one of the economic consequences of intra-group reinsurance.\(^\text{19}\)

There is no major property and casualty insurer or reinsurer, or life reinsurer, that only underwrites risks situated in a particular country or region. (Note that many of the largest insurance and reinsurance markets, while located in centers such as London or Munich, are markets for the placement of global wholesale risks by airlines, shipping firms, engineering groups, professional services firms seeking indemnity cover, etc.) This is because without diversifying geographical risks, no property and casualty insurance group is able to operate on a commercial basis in one country or region given the additional capital requirements that would be generated due to the risk concentration.

Reinsurance (both external and intra-group) is a means to:

- Provide insurance capacity to the markets, particularly smaller markets -- for example those vulnerable to natural catastrophes where local insurers may not otherwise be able to meet liabilities or lack diversification within their portfolio.
- Smooth volatility, reduce capital requirements, and improve returns to investors.
- Access expertise and knowledge of specific markets, products, and risk management solutions.

\(^{18}\) OECD Guidance on Transfer Pricing Aspects of Intangibles, 16 September 2014, paragraph 1.98 et seq.

Intra-group reinsurance is a means to:

- Provide capital at the level of the insurer, also reducing the risk of "stranded capital" which could happen if other forms of capital were used instead.
- Protect the local insurer against significant insurance losses arising on the business it has underwritten.
- Pool risk and accordingly achieve diversification, which inherently frees up capital to be used most efficiently. Capital can then be redeployed to write more business either in existing or new markets.
- Satisfy regulatory requirements, which under Solvency II reward the pooling and diversification of risks.
- Allow for the movement of capital in order to manage liquidity risk. Ordinarily, group capital and liquidity requirements are managed from the location of the intra-group reinsurer.
- Obtain greater purchasing power by combining risks before seeking external reinsurance.
- Better manage investments that are core to an insurance company by pooling assets in an entity that supports reserves, potentially enabling greater investment in higher risk but higher yielding assets.

Group pooling of risks through intra-group reinsurance is needed despite the common ownership of the group by a single parent company. Regulators require insurance entities within their jurisdiction to maintain capital on a stand-alone basis, in order to meet liabilities to policyholders. One entity cannot bear the risks of another entity without some formal arrangement such as reinsurance that is approved and monitored by the regulators.

Therefore, the so-called economic family argument is not relevant in this context. In the case of insurance groups, the underlying risks are third party risks, and pooling and distributing these risks is a fundamental element of the insurance business. Reinsurers do not compensate primary insurers for regulatory capital costs, but only for costs of sourcing the ceded business, since the primary insurers benefit from a reduction in regulatory capital requirements for the business that is reinsured. It also should be noted that a reinsurer cannot push any losses from ceded risks back on to the cedant.

The role of risk and capital in the insurance industry is different from the role of risk and capital in other industries.

For insurance groups, regulatory and accounting rules and other factors effectively require that income be aligned with the value-creating factors of underwriting and capital. Stringent regulatory requirements regarding capital and other issues apply to insurers and reinsurers because the insured risks are those of third parties. In addition, rating agencies’ judgments regarding the financial soundness of insurers and reinsurers have a direct effect on the ability to fund new business and the capital to support that business.

Insurance groups may apply consistent underwriting standards across the group, often set at group or division level but with each regulated insurance or reinsurance entity being required by regulators to have governance structures in place to adopt and adapt underwriting guidelines.
through appropriate committee frameworks. This would include the entity with which insurance subsidiaries reinsurance. These standards can include:

- Limits on the particular types, and volumes, of risks that can be underwritten;
- A requirement that permission be sought if those limits or large risks are to be underwritten; and
- Maintenance of a strong Enterprise Risk Management framework; such frameworks are actively assessed and reviewed by regulators and rating agencies.

Due to these factors, the intra-group reinsurer is a vital part of an insurance group’s overall value chain and plays an active role in managing risks underwritten by the insurer, and transfer pricing analysis should not fail to recognize these functions.
Mr. Andrew Hickman  
Head of Transfer Pricing Unit,  
OECD Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris  

Submitted by Email to transferpricing@oecd.org  

6 February 2015  

Dear Mr. Hickman  

Submission in response to OECD Discussion Draft on the Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures)  

Please find enclosed our submission in response to the Discussion Draft on the Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures) that was released on 19 December 2014.  

The Irish Institute of Tax and our members acknowledge the importance of the OECD’s work in this area. On behalf of our members, we submit comments in response to the efforts by the OECD to address two challenging and technical areas of both transfer pricing and international taxation.  

We would like to thank Warren Novis and the Transfer Pricing team from KPMG Ireland for their assistance in preparing our submission and gathering input from members in the Irish Tax Institute.  

We are available for further discussion on any of the matters raised in our submission.  

Yours truly,  

Andrew Gallagher  

President  
Irish Tax Institute

Andrew Gallagher – President, Mark Barrett, Marie Bradley, Colm Browne, Dermot Byrne, Sandra Clarke, Ciaran Desmond, David Fennell, Karen Frawley, Ronan Furlong, Lorraine Griffin, Johnny Hanna, Mary Honohan, Jim Kelly, Martin Lambe (Chief Executive), Aoife Lavan, Jackie Masterson, Tom McCarthy, Frank Mitchell, Frank Ryan, Kieran Twomey. Immediate Past President – Helen O’Sullivan.
Irish Tax Institute

Response to OECD Discussion Draft: Risk, Recharacterisation and Special Measures

February 2015
About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland’s AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.
Our response

The Irish Tax Institute is writing in response to the Discussion Draft on the Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures), which the OECD released on 19 December 2014. We prepared this submission with consideration and input from a number of our members.

Introduction

Actions 8, 9 and 10 of the OECD’s Base Erosion and Profit Shifting (BEPS) project focuses on the alignment of transfer pricing outcomes with value creation. We believe that the Discussion Draft provides much clearer guidance, in particular the emphasis on aligning contractual terms with the parties’ actual conduct. However, there are several recommendations in the Discussion Draft which we consider inconsistent with observed dealings between independent parties and do not address key issues underpinning the challenges of designing workable outcomes from the BEPS project.

The Irish Tax Institute recognises the importance for legislators and tax authorities to identify and prevent transactions structured to inappropriately abuse tax rules. It is critical that BEPS solutions to prevent abusive transactions do not disproportionately disadvantage the majority of transactions which are supported by adequate substance. A lack of balance in the BEPS solutions will greatly increase tax disputes and double tax cases, and result in overburdened tax authorities and taxpayers.

Our key concerns in the Discussion Draft are two-fold. Firstly, the Discussion Draft diverts a primary goal of the OECD Model Tax Convention on Income and Capital, which is to “clarify, standardise, and confirm the fiscal situation of the taxpayers”. The direction taken is largely creating uncertainty for taxpayers. Second, the Discussion Draft ignores the economic importance of assets and capital that is required by independent parties to perform their functions and to assume contractually obligated risks.

Part I of the Discussion draft contains new guidance to Chapter I of the OECD Transfer Pricing Guidelines for Multinational Enterprises (“the OECD Guidelines”). The new guidance focuses on the relevance and allocation of risk as well as sets conditions where recharacterisation or non-recognition of transactions would be appropriate.

Part II of the Discussion Draft is a preliminary consultation on the applicability of five distinct measures to address BEPS issues with intangible assets, risk and over-capitalisation. This movement towards special measures for transfer pricing matters departs from the fundamental reliance on the arm’s length principle and should be thoroughly considered before any recommendations are made.

A. Part I: Revision to Chapter I Section D of the OECD Guidelines

A core objective of the OECD Guidelines has been to set rules with reference to arm’s length dealings in such a way that taxpayers can comprehend and comply, and that tax authorities can reasonably enforce. Another core objective is to provide sufficient guidance on applying the arm’s length principle that enables transfer pricing disputes to be settled in a reasonable fashion. These disputes can occur between taxpayers and tax authorities as well as between tax authorities. Part I of the Discussion Draft significantly increases the complexity of the OECD Guidelines, and will likely result in greater disputes.

Our more specific commentary is as follows:

1 Actual conduct of the parties

The emphasis on actual conduct of the parties is viewed as a positive change, and consistent with other OECD developments in the transfer pricing area. The importance of substance and conduct is consistent with themes in Chapter IX of the OECD Guidelines which applies to business
restructurings. This Chapter directs the allocation of risk to follow the conduct of parties as well as economic principles governing the parties. As well, the OECD’s ongoing work on intangibles places emphasis on each party’s conduct to establish an appropriate allocation of risk, and value, from the creation of intangible assets.

2 **Should focus on “when” not “who” in determining appropriate risk allocation**

Tax authorities should not be able to exploit the benefit of hindsight and enforce adjustments on an *ex-post* basis. Part I appears to empower tax authorities to make retroactive adjustments to terms based on *ex-post* determination of the risk allocation in the original intercompany transaction.

It is recommended that the OECD Guidelines continue to advocate that tax authorities respect the contractual terms of the intercompany transaction where the parties have sufficiently demonstrated the arrangement was entered into under arm’s length conditions at the time the contractual arrangement was entered into. Parties that assume risk may be rewarded with a successful outcome or suffer a loss for an unsuccessful outcome. Taxpayers have the ability to contemporaneously document and support their risk allocation at the time the transactions are entered into, relying on forecasts in connection with the transaction. Timely prepared and complete documentation should be adequate evidence to determine whether the transaction was and is in compliance with arm’s length **expectations**. Once this is demonstrated, there should not be a requirement to monitor, thereafter, the allocation and management of risk between the parties.

In addition, an unreasonable burden would be imposed on taxpayers to identify - for each transaction – potential risks, assumption of external risks, potential consequences and risk management measures in order to determine the appropriate pricing for the transaction.

3 **Evidence of arm’s length risk allocation**

As noted above, contemporaneous evidence of the arm’s length risk allocation should be sufficient to document the transaction or arrangement. However, it is recognised that arm’s length evidence (i.e. comparables) for the same period are not ordinarily available at the time parties are agreeing to a risk allocation. When taxpayers prepare transfer pricing documentation for contemporaneous compliance, they employ a standard practice to use best available comparable data relevant for the period. Comparable data may include evidence of arm’s length risk allocation, with reference to third party agreements.

As time progresses, more comparable data relevant to the period is often available for the benefit of tax authorities. The proposed revised OECD Guidelines appear to provide tax authorities with greater freedom to scrutinise risk allocations, and apply hindsight to the arm’s length evidence of the risk allocation. If such freedoms are available, taxpayers will begin to question the purpose and value of preparing contemporaneous documentation. We strongly suggest the OECD provide thorough guidance on what is (and is not) acceptable evidence of arm’s length risk allocation, from a technical and administrative perspective.

4 **Increasing the profile of subjective measures**

The focus on subjective measures is likely to increase disputes between taxpayers and tax authorities by increasing the reliance on subjective matters such as risk allocation and risk management. Risk is defined as “the effect of uncertainty on the objectives of business” in the proposed Discussion Draft, which is inherently subjective in nature.

There is also a likelihood of disagreement in both the possible interpretation and identification of key risks based on their evaluation of the facts at a different point in time.
5 Inconsistency with Chapter IX (control and financial capacity)

The proposed new language in the Discussion Draft fails to recognise the importance of assets/capital that is required by the parties to perform their contractual functions and assume risk. Part I undermines rather than reinforces the framework under Chapter IX which purports that risks would follow capital or people functions.

6 Increased likelihood to non-recognition or recharacterisation

The ability to set aside transactions ratified by both the tax authority and the taxpayer makes it difficult to deal with double taxation issues in the MAP process. If non-recognition or re-characterisation becomes more frequently applied by tax authorities, under the new Part I terms, taxpayers will face significant uncertainty on their ability to obtain relief from double tax. There should be significantly greater consideration of trickle down deterrent effect on taxpayers to enter into MAP arrangements.

It is suggested under the Discussion Draft that business arrangements can be disregarded so long as it is justifiable by an ex-post analysis of the risk allocation between the parties. The OECD Guidelines should again strongly caution against the use of hindsight to apply ex-post facts to re-evaluate the terms of the transaction. As mentioned earlier, if the taxpayer contemporaneously documents the transaction and risk allocation were arm’s length at the time of entering the arrangement, then such terms should be respected throughout the life of the arrangement.
B. Part II: Potential Special Measures

Overview

When outlining the need for special measures, Part II of the Discussion Draft notes that the proposed changes in Part I may not be sufficient to re-align transfer pricing outcomes with value creation. Hence, the OECD has presented a consultation on five measures that go beyond the arm’s length principle to limit the potential for perceived BEPS.

Only Option 1 of the special measures is related to transfer pricing - the pricing of transactions between related parties. All other measures reach beyond transfer pricing and into re-designing territorial tax systems. It is more reasonable that Option 1 remains a transfer pricing matter covered by BEPS Action 8, 9 and 10, while the other measures do not.

Many observers to the BEPS project will be aware that in certain jurisdictions there are taxation rules that are similar to some of the special measures. We understand that Action 3 of the BEPS project (Strengthen CFC Rules) is intended to address the non-taxation issues raised in Part II. A discussion draft under Action 3 is expected in April 2015. We recommend that the OECD defer further work or consultation on Options 2 to 5, and cede the work undertaken to those responsible for Action 3.

General concerns with special measures

Part II of the Discussion Draft suggests circumstances which may warrant a special measure to avoid inappropriate profit distribution, but, as noted earlier, Part II offers no details on how this work is connected to other BEPS actions.

Part II of the Discussion Draft has created unease for multinationals because it fails to provide adequate guidance on how recommendations will be drafted to enact any of the special measures. Both tax authorities and taxpayers seek and benefit from certainty and predictability in their tax environment. To provide certainty, there is an urgent need for consistency between the recommendations that may result from this Discussion Draft and existing rules, and to minimise the double tax consequences that can easily result from special measures.

It will be critically important that during this consultation of special measures, the OECD commits to “clarify, standardise, and confirm the fiscal situation of the taxpayers”. With these special measures, it is foreseeable that multinationals may not receive fair or consistent application of new rules by tax authorities, and as a result, lead to substantial levels of double taxation.

Finally, to avoid the creation of double taxation, a two-sided mechanism must be addressed in future Discussion Drafts so that any ex-post adjustment by one tax authority is required to be recognised by the tax authority of the counterparty jurisdiction, as long as there is a tax treaty available to avail of double tax relief. The work on Action 14 (Making dispute resolution more effective) focuses on issues currently faced by taxpayers and tax authorities. It is critical that Action 14 also considers and addresses the future double tax scenarios that are likely to result from this and other Actions.

Option 1: Hard-to-value intangibles

The proposed special measure involves a presumption of a price adjustment rule where the price of a transaction is fixed, either as a lump sum or a royalty rate. This measure allows the benefit of hindsight to re-price transactions. The OECD Guidelines cautions against the use of hindsight when third party contracts would not grant such rights to the parties.

As noted earlier, we suggest the OECD Guidelines strongly caution the use of hindsight except in abusive situations. It should be strongly phrased in the Guidelines that if a taxpayer has demonstrated compliance with arm’s length expectations, through complete contemporaneous documentation, it
should be prohibitive for tax authorities to retro-actively adjust prices of certain transactions if risks materialised different from expectations.

Rules similar to the proposed measures that allow a retro-active price adjustment already exist in the United States transfer pricing rules. The Commensurate with Income rules (CWI) in the US transfer pricing regulation allow for a variance from the projections used to set the price in connection with the transfer of an intangible asset. CWI also limits the retro-active period to a finite amount. While we are not in agreement with such measures, we recommend any future development of this special measure ensures consistency in principle with existing transfer pricing or tax regulations.

In particular, the Discussion Draft lacks a requirement to restrict the number of years tax authorities may “look back” to review a transaction. The current wording provides leeway to tax authorities to review these transactions without limitation.

**Hallmarks of CFC regimes**

Options 2 through 5 are intended to address inappropriate returns for providing capital. These options introduce new rules that appear like the foundation of CFC regimes. It is our view that a well-crafted CFC regime should at least have these four characteristics:

1. rules that define a CFC;
2. clear definitions of what constitutes bad CFC income versus good CFC income;
3. consistent and clear thresholds for substance (e.g. number of employees, materiality of third party revenue, etc.); and
4. specific rules stating when the CFC income (good or bad) will be subject to tax in the parent company’s jurisdiction, if at all.

**Option 2: Independent investor**

This special measure is intended to address inappropriate returns to capital-rich, asset-owning entities that are dependent on other group companies to generate returns on those assets. The proposed measure is to attribute the return associated with the capital-rich, asset-owning company to the parent company, as if the parent company made a direct investment in the asset.

The description of this measure is light and requires greater detail on how the re-allocation of income would occur in practice. Any inappropriate allocation of income to such an entity is generally addressed in well-crafted CFC regimes. We strongly recommend that any special measure that is similar to a CFC measure should be addressed in Action 3.

**Option 3: Thick capitalisation**

The thick capitalisation special measure involves deeming interest on the capital amount that is considered excessive capital allocated to a capital-rich, asset owning company. The measure would deem interest expense on this company and interest income on the company providing the excess capital. The Discussion Draft suggests that fixed ratios of thick capitalisation could be referred from capital adequacy of a regulated financial services business.

In our view, there is a fundamental mismatch in the purpose of the proposed thick capitalisation ratio and capital standards for regulatory reasons. Any maximum capital threshold suggested in this special measure would be counter-intuitive to the minimum capital levels required by a financial regulatory regime. Further, there is a lack of guidance on how to determine the pre-determined capital ratio which makes practical application difficult and arbitrary.

The application of transfer pricing principles must adhere to how arm’s length parties conduct business. It is often the case that independent companies, both small and large are fully capitalised by
equity and carry no interest-bearing debt. Hence, we suggest that any special measure deeming debt on an entity solely because of its capitalisation contradicts the basis of the arm’s length principle and Article 9 of the Model Tax Convention.

It is important to recognise the connection between this measure and Action 4 (Interest Deductions and Other Financial Payments), which is advocating rules limiting intercompany interest deductions through thin capitalisation and other methods. Multinationals generally borrow externally such to reduce the overall financial cost to the business. This might be at the parent company level. Amounts are then lent within the organisation in compliance with transfer pricing and other taxation rules.

Thin capitalisation threshold in certain countries are a fixed formula, and are indifferent to external borrowings of the organisation. It appears contradictory on one hand to support measures that deny deductions for interest that based on external costs, while on the other hand not permitting the capitalisation of an entity without debt. We suggest that both sides of the capitalisation spectrum are treated equally.

**Option 4: Minimal function entity**

The special measure addressing minimal function entities (MFE) re-allocates the profits of the MFE to companies providing the relevant functional capacity that create the profits of the MFE. Both qualitative and quantitative thresholds are suggested to determine whether a company qualifies as an MFE. Qualitative attributes address functional capacity, whereas quantitative attributes measure employees, source of income, and value of the assets.

A key concern is the qualitative attributes suggested in the Discussion Draft are subjective, providing for disputes between taxpayers and tax authorities, and between tax authorities. Further, it would be challenging to derive reliable and consistent quantitative measures that would apply across jurisdictions and across industries.

Since this special measure suggests the profit split as a way to re-allocate the profits of an MFE, we strongly recommend there is a clear nexus with Action 10 on the application of the profit splits to global value chains. Because the draft suggest that profits of an MFE may re-allocated to multiple parties performing the functions, this option creates the possibility of multiple tax authorities seeking to tax the same income of an entity deemed an MFE. There is already disagreement amongst tax authorities in applying the arm’s length principle. Triple taxation, or worse, is a foreseeable outcome of this option and should be avoided where possible.

**Option 5: Ensuring appropriate taxation of excess returns (CFC rule)**

The fifth special measure involves the application of a primary or secondary rule, akin to a CFC regime, aimed at preventing non-taxation. This measure would apply to CFCs earning excess returns in low tax jurisdictions.

We are extremely concerned with the ‘effective tax rate’ approach outlined in the primary rule. A CFC approach specifically targeting effective tax rates has a high likelihood of collateral damage beyond the intended non-taxation in tax havens. Concerns over harmful tax practices are being addressed in Action 5 and encourage the outcome of Action 5 to distinguish between inappropriately reduced effective tax rates from appropriately reduced effective tax rates.

There are a number of reasons why effective tax rate is not a suitable benchmark. For instance, effective tax ignores the impact of losses carried forward. The Discussion Draft suggests a three-year period to evaluate effective tax rates. Lifecycles of a business, whether it supplies good or services, can easily extend beyond three years. Losses incurred in the development stages may reduce taxes on future profits for many years to come. Such business realities must be considered in developing any new rules.
There is also a high risk of different thresholds being adopted by local law leading to increased disputes and triggers a need for constant re-evaluation of the threshold. Some countries may wish to specify a fixed percentage (as suggested in the Discussion Draft). Others may set the threshold relative to their own corporate tax rates, e.g. Swedish CFC law applies to income subject to taxation at a rate less than 55 percent of the Swedish rate.

We see this measure will be very difficult to implement into law so that it achieves a consistent approach to allocate excess income across multiple jurisdictions. There is a significant amount of work required to attain the buy-ins from tax authorities from multiple jurisdictions which could be hard to achieve.

Overall, we strongly suggest the OECD stops any further work on Option 5 pending the outcomes on both Action 3 and Action 5.