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
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6th February 2015

Andrew Hickman
Head of Transfer Pricing Unit
OECD/CTPA

For e-mail transmission to: TransferPricing@oecd.org

Dear Mr Hickman

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 inviting comments on the above Discussion Draft, issued on 19th December 2014.

The International Underwriting Association of London (IUA) represents international and wholesale insurance and reinsurance companies operating in or through London. Its purpose is to promote and enhance the business environment for its members. We estimate that premium income for the London company market in 2013 was some £24bn.

We are grateful for the opportunity to comment on proposals intended to achieve the objectives of Actions 8, 9 and 10 of the BEPS Action Plan to ensure that transfer pricing outcomes are in line with value creation. As insurers and reinsurers, our members deal with risk assumption, management and transfer on a daily basis as "risk carriers". As multinational corporate groups, our members also monitor, evaluate, manage and control risks which affect the business, financial condition and results of operations of the MNE as a whole.

Summary comments

1. We welcome the clear statement of principle that transfer pricing analysis should be based on the contractual terms and the actual business conduct of the parties. Aligning the transfer pricing approach with how businesses are organised should mean that the analysis of value generation is aligned with how businesses see themselves generating value.

2. We are, however, concerned that the inclusion of concepts such as moral hazard and the lowering of the barrier for recharacterisation of transactions, represent a move away from the arm's length principle. Business needs certainty and the arm's length principle, as accepted by OECD countries, the BEPS project and MNEs, is the best way of providing this. The introduction of special measures, or a move towards greater recharacterisation would reduce certainty and increase disputes and double taxation.
3. As a practical measure, we suggest that guidance on setting a materiality threshold be given to ensure that only significant transactions are subjected to the full documentation process. That would allow businesses to focus their scarce resources on the areas of significant risk. In addition to providing clarity on what needs to be documented and in what level of detail, this approach would be in line with the approach to risk assessment applied by MNEs in risk management outside of tax.

4. We do not see that special measures should be required to deal with areas of residual risk, as we believe that such areas can be addressed by applying the comparability analysis and, where necessary, recharacterisation as set out in Chapter 1. If special measures are introduced, we suggest that, before applying them, tax authorities should be required to show that they have carried out an analysis in accordance with Chapter I of the Discussion Draft and to set out the reasons why their analysis is insufficient to arrive at outcomes in line with value creation.

5. We recommend that further detail be included in the Discussion Draft on the nature of capital for MNEs in general and in particular for MNEs in regulated sectors. That would help to inform the discussions on what it means to be over-capitalised or thickly capitalised.

6. We welcome references to specific regulatory constraints which have an impact on insurers (D.1 paragraphs 66 and 86). Certain of the general comments on risk are not applicable to insurance companies— we would draw particular attention to D.1 paragraphs 38, 39, 60, 61, 67, 72 and 78. That should be considered in further detail in the Draft. We discuss the point at paragraphs 12 and 13 below.

7. The business of financial services is dealing with risk and, therefore, we suggest additional analysis be included on the nature of risk from the perspective of MNEs in the regulated financial services sector. For insurers, we consider that much of that analysis is already set out in Part IV of the OECD’s Report on the Attribution of Profits to Permanent Establishments and the relevant sections could be incorporated as an appendix to the Draft.

**Identifying commercial or financial relations**

8. We understand the desire to identify situations where the actual conduct of the parties diverges from the written document and welcome the acknowledgement that there is a wide spectrum of divergence between absolute adherence to the contract words and a situation where the contract bears little resemblance to the actual conduct of the parties.

9. We would want, however, to add a note of caution: the conduct of the parties should not be subject to a stricter level of scrutiny than a third party contract. The Draft notes (at paragraph 5) that “Where conduct is not fully consistent with contractual terms, further analysis is required …”. It should be acknowledged that, even in third party contracts, there can often be small differences, perhaps arising over time, perhaps due to “scope creep” or due to the different level of detail between the scope of services in an agreement and operational performance, between the words in the contract and the actual conduct. Such differences between contract terms and actual conduct, so long as they do not affect the economic substance of the agreement, should not enable tax authorities to re-analyse and delineate a different transaction or additional transactions.

10. The examples provided appear to describe everyday business situations. It would be helpful if examples were provided showing more clearly the types of activity the BEPS project aims to target. That would also provide greater certainty to businesses which have genuine and compliant transactions.
Identifying risks in commercial or financial relations [36-78] [D.2]

11. We welcome the expanded consideration of risk and the risk analysis framework, although we would note that this needs to be reviewed for consistency with Chapter IX of the Transfer Pricing Guidelines.

12. The following comment in paragraph 38 is not applicable to insurance companies:

*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.*

An insurance company does not control the risks it assumes, but takes on those risks on certain terms (the basis of cover) and for a price (the premium) and manages the risks assumed in a number of ways, including by diversification and through reinsurance. The comment “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” should be noted as not applicable to insurance companies.

13. The last sentence of paragraph 67 is also not applicable to insurance companies and we suggest it be amended to reflect this point. Insurance companies provide insurance cover for risks priced by reference to terms and conditions. This includes cover for areas such as professional indemnity, which could fall into the category of core competencies.

14. Paragraphs 55 and 56 suggest a very detailed and granular analysis is required to support the transfer pricing policy for attributing and rewarding risk. It would be helpful therefore to have guidance on the level of analysis that is expected to be specifically prepared for transfer pricing purposes, in addition to collating the existing documentation prepared by the MNE for non-tax risk management purposes.

15. We suggest including guidance to enable groups to set a materiality threshold for those significant transactions which would require full documentation. That would enable groups to vary the extent and the depth of transfer pricing analysis in line with their risk assessment.

16. We would welcome further guidance on how it is proposed to allocate rewards between the management and control of risk referred to in paragraph 55. It is not clear to us, and we believe it would not be clear to tax administrations, how management and control of risk are to be treated differently. We are concerned that could lead to varying interpretations by different tax authorities, resulting in increased disputes.

17. Paragraph 78 appears to imply that ex-post pricing should be considered if ex-ante pricing does not give the expected result. Further clarity on what is meant here and the circumstances where profits might be adjusted would be welcomed here. Ex-ante pricing is at the core of the insurance industry business model and we do not consider it appropriate to apply ex-post tax adjustments to ex-ante prices, particularly in an industry which adopts ex-ante pricing in its third party transactions.

18. It would be helpful to provide more discussion in this section of the Draft on how capital contributes to the capacity to bear risk, particularly in the context of regulated financial services entities. Paragraph 66 refers to financial capacity to bear risk. We suggest that the paragraph should be extended to discuss the need for financial capacity in the event of losses.
D.4. Non-recognition [83 ..]

19. We endorse the draft’s emphasis [in paragraph 82] on the point that “the mere fact that the 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 the fundamental underlying basis of the arrangements that matters, not whether the same transaction is observable between independent parties”. We would be grateful for further confirmation that recharacterisation should only be considered only after a full comparability analysis has been performed.

20. As non-recognition is to be considered “in exceptional circumstances” we recommend clear criteria are set out for circumstances in which non-recognition could be applied (together with examples of the type of situations being targeted). Paragraph 84 states that “Where the same transaction can be seen between independent parties in comparable circumstances, non-recognition would not apply”. It would be helpful for some clarification of “same” and “comparable” in this context. If this is taken to mean where a comparable uncontrolled price could be applied, then the wording is too restrictive and gives little guidance on the circumstances where non-recognition might be considered. If it is different from when a CUP is appropriate, then some further detail on what is meant would help taxpayers in their analysis of transactions.

21. We propose that where a tax authority wishes to recharacterise a transaction, it should be required to demonstrate that the existing transfer pricing analysis is inadequate.

22. Paragraphs 89 and 92 appear to suggest that comparing pre- and post-tax results for the MNE group as a whole is a criterion for non-recognition. This would be a departure from an arm’s length principle and the existing accepted basis for comparability, which considers a transactional pre-tax basis to arrive at a comparable price.

Moral hazard, risk-return and financial services sector [between 40 and 41]

23. It is not always the case that third parties will only accept risk if they can incorporate safeguards or incentives into contractual arrangements: third party insurance is an example of a transaction where risk is taken on without such contractual safeguards.

24. The risk-return trade-off is at the core of the insurance (and reinsurance) business and we would be grateful if this is acknowledged in the draft.

25. The discussion of risk of a general nature also applies to the financial services sector. It is important to note that, in this regulated sector, risk and risk transfer are at the core of the business. For insurance groups, a distinction should be made between risk of a general nature which is equally applicable to all companies, and risk as the stock in trade of the insurance business. In discussing the latter, the importance of the relationship between risk and the capital to support the risk should be made clear, together with the importance of the regulatory framework in which such groups operate. We would welcome the opportunity to provide input into a separate chapter or appendix on risk for insurance companies, in the same way that Part IV of the OECD Report on the Attribution of Profits to Permanent Establishments was written to supplement Part I of that Report. We note that many sections of Part IV could be incorporated into the discussion draft as they are currently written.

Special measures

26. We do not consider that special measures are needed. An analysis following the principles set out at the beginning of Chapter I, involving an assessment of the actual contract and the actual conduct of the parties, together with the information provided in country by country reporting from Action 13,
should be sufficient for a tax authority to audit and identify situations where there is a significant deviation between the documented position and the actual conduct and to adjust accordingly.

27. The discussion draft notes that even by following the transfer pricing principles in Chapter I, there are residual risks 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”. It is our view that a properly conducted transfer pricing analysis taking into account all the entities within the group and their respective functions should, in the absence of fraud or concealment, address such residual risks.

28. We consider that options 1, 2 and 3 could be addressed by applying transfer pricing principles without the need for special measures. As for Option 4, we consider that it would be inappropriate to apply this to insurance companies without significant adaptation. Capital is an essential component of an insurance business. It is required to absorb risk and without it insurance business cannot be carried on. Capital management is an integral part of an insurance business, as insurance groups operate within specific capital and regulatory constraints. Different types of insurance business require different levels of capital and the amount of capital within an insurance company is a key management decision taken based on regulatory and other commercial considerations.

29. We are concerned that the existence of special measures will undermine the arm’s length principle. We believe any move away from the arm’s length principle is damaging to the existing international agreement around the use of transfer pricing methodologies. Special measures which go against the arm’s length principle should be discouraged as far as possible as they undermine the basic premise that it is possible to arrive at an arm’s length price for an arrangement regardless of whether the same transaction is observable between independent parties (as noted in D.4. 83).

30. We have a concern that some tax authorities might, if under-resourced, go straight to special measures without going through the rigorous and detailed analysis required in Part I.

31. To minimise uncertainty, there needs to be a clear set of criteria, agreed by all tax authorities consistently, for circumstances in which special measures will be applied. In the absence of this, tax administrations are likely to apply individual, varying, interpretations of the special measures, creating uncertainty and leading to disputes and double taxation.

32. We suggest that before applying any special measures, tax authorities should be required to show that they have carried out an analysis in accordance with Chapter I and to set out the reasons why their analysis is insufficient to produce an adjustment which results in an outcome in line with value creation.

33. We believe there needs to be an agreed dispute resolution mechanism to avoid double taxation. Given the likelihood of increased disputes, there is a key interaction here with the output of Action 14 on dispute resolution.

Conclusion

In summary, we support the discussion draft’s objective of aligning transfer pricing with business reality. We welcome the more detailed consideration of risk and recommend including further discussion of both risk and capital from the perspective of insurers to help the analysis of transactions involving insurance groups. We are concerned that there appears to be a move away from the arm’s length principle through lowering of the barrier for recharacterisation of transactions without sufficient safeguards to ensure this is applied only in the appropriate circumstances.
To ensure that compliant taxpayers have certainty, and to ensure that the documentation requirement is proportionate, we would welcome the inclusion of a threshold for documentation, further examples of situations being targeted, and specific criteria for when non-recognition might be in point. We hope you will find these comments helpful and would be keen to engage further with you on these guidelines.

Yours sincerely

N. J. Lowe

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Mr. Andrew Hickman,
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Comments on the Discussion Draft on Actions 8, 9 and 10
(Revisions to Chapter I of the Transfer Pricing Guidelines (including risks, recharacterisation, and special measures) of the BEPS Action Plan

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) in response to the invitation to public comments by the OECD regarding the “BEPS Action 8,9,10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)” released on December 19, 2014.

The JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of JFTC’s Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

Part I (Revisions of Chapter I, Section D of the Transfer Pricing Guidelines)

General Comments

1. While various economic activities are taxable under tax laws, such activities are primarily governed by private laws. Therefore, in order to ensure legal stability under tax laws, in principle, taxes should be levied in accordance with the legal relations under the private laws.

2. The existing Transfer Pricing Guidelines indicate that non-recognition and recharacterisation of terms of contract under private laws for transfer pricing
purposes should be limited to the exceptional cases. We are concerned that, if the Guidelines were to be revised based on the present Discussion Draft, tax authorities may disregard and recharacterise the actual transactional conditions due to lack of economic attributes, without considering the facts and circumstances of the transactions sufficiently.”

3. Most taxpayers consider the risk control and corresponding risk allocation from a point of view of the business operations and reflect them into the terms and conditions of associated enterprise contract, and further, explain its rationality in their transfer pricing documentation. Nonetheless, if tax authorities dare disregard such analyses and recharacterise the transactional conditions, they should bear the burden of proof. However, it would be difficult to prove in most cases.

4. Therefore, non-recognition and recharacterisation should not be used except in abusive cases in which taxpayers set artificial transaction terms in the contract with the intent to avoid taxation.

Specific Comments

D.2 Identifying risks in commercial or financial relations
<Paragraph 42>
➢ Commercial activities entail various types of risk. In order to avoid unproductive disputes on the allocation of risks, the scope of risks for transfer pricing purposes should be limited to risks assumed, for which an independent person would be compensated. Some risks, such as force majeure risk, cannot be managed, and no one would be compensated for such risks assumed. Therefore, such uncontrollable risks should be excluded from the scope of the proposed Guidelines.

<Paragraph 67>
➢ A trade-off relation exists between the acceptance of risk and future opportunities for earning high returns. Therefore, it is difficult to uniformly determine whether or not the payment and acceptance of compensation is necessary between associated enterprises for the transfer of risk. Based on the arm’s length principle, the Guidelines should stipulate that compensation be paid for risks that generally entail the payment and acceptance of compensation between third parties. This point should also be
explicitly stated in Chapter 9 (Business Restructuring) of the Guidelines. We believe no need for compensation arises for the transfer of risk, at least in cases where risk allocation is not appropriate and risk is transferred to an associated enterprise that is capable of appropriately managing the risk (for example, when a subsidiary of a MNE group transfers high-risk transactions to an associated enterprise because it lacks the ability to control growing credit risk resulting from increased volume of transactions).

<Paragraph 75>

- Explanations with specific examples should be presented, including on the extent of comparison required on risks of the controlled and uncontrolled enterprises as stated in the Discussion Draft within the scope of publicly available information, and what the appropriate form of adjustment is in case differences exist in the level of risk assumption.

D.4 Non-recognition

<Paragraph 83,84>

- A tax authority’s non-recognition of the terms of a contract entered into by a taxpayer without full presentation of the reason is inappropriate because this may lead to denial of the self-assessment tax filing system itself.

Non-recognition and recharacterisation of contractual terms should be restricted to abusive cases.

- With regard to non-recognition and recharacterisation of contractual terms, measures should be taken to ensure elimination of double taxation. For this purpose, the two tax authorities related to the case should be required to engage in prior consultation on non-recognition and recharacterisation of contractual terms and to notify the taxpayer of the agreed results in writing. This notification must include the rationale for the decision requiring non-recognition and recharacterisation, and an explanation of the method of recharacterisation. A rule should be established to the effect that non-recognition and recharacterisation cannot be made if the two tax authorities are unable to reach any agreement.

- Even if the above suggestion for prior consultation between tax authorities is not adopted, taxpayers should be afforded an opportunity for rebuttal prior to the non-recognition. Moreover, it should be clearly indicated that mutual
agreement procedure through the competent tax authorities will be ensured to taxpayers.

Tax authorities have a responsibility to present taxpayers with an earnest explanation based on objective evidence of the reasons for non-recognition and recharacterisation of a transaction. Therefore, it should be explicitly stated that the burden of proof rests with the tax authority.

➢ The examples given in paragraphs from 90 to 94 are extreme. We are afraid that they would increase the incidence of non-recognition by tax authorities on grounds of the lack of “fundamental economic attributes” even in cases of normal transactions between associated enterprises with no intent of tax avoidance, and would thereby unreasonably obstruct the economic activities of enterprises. To ensure predictability for taxpayers, there is a need to create a mechanism for prior agreement between tax authorities or between a tax authority and a taxpayer on the existence of “fundamental economic attributes.”

<Paragraph 93>
➢ Non-recognition should be avoided as much as possible. However, for cases requiring non-recognition, we request that the method and process for recharacterisation following non-recognition be explicitly set forth in the Guidelines.

➢ If the terms of contract established under private laws are to be subject to non-recognition, consistency with tax systems other than transfer pricing must be secured. For example, consider the non-recognition of a license agreement under transfer pricing that is then recharacterised as a different form of contract. In this case, it would be necessary to simultaneously return the withholding tax paid on the royalties. It would also be necessary to simultaneously revaluate customs duties that have been levied.

Part II (Special Measures)

Option 1: Hard-to-value intangibles (HTVI)

➢ Available information on profitability etc. differs between the time when the value of an intangible asset is computed and when profit derived from an intangible asset is actually realized. Empowering tax authorities,
notwithstanding this difference, to adjust the price simply on the grounds that the result of the transaction differs from the initial estimate would seriously undermine predictability for taxpayers. Explicit provisions should be included mandating tax authorities to present taxpayers with a full explanation of why price adjustment is appropriate. Moreover, it should be explicitly stated that the burden of proof rests with tax authorities in such cases.

- We request measures such as that the tax authorities respect the valuation made by taxpayers, and price adjustment be unnecessary for an enterprise that has appropriately undertaken prior computation of the value of an intangible asset, prepared necessary and sufficient documentation, and provided the tax authorities with sufficient information. Moreover, realized profits may not necessarily be generated solely from the transferred intangible asset in question. Therefore, in determining whether or not price adjustment is necessary, due attention should be paid to the fact that careful analysis of the source of profit is necessary.

- With regard to documentation requirements for transfer of intangible assets at a fixed price, it should be explicitly stated that taxpayers should not be forced to undertake excessive burdens.

- Uniform application to all intangible asset transactions for which contingent payment mechanisms have not be established would place a restriction on rational taxpayer activities. For example, consider a case in which the transferred intangible asset yields a profit that falls below the initial plan. Under a contingent payment mechanism, the transferor would have to return part of the compensation received for the transfer to the transferee. This would result in double taxation if the returned amount cannot be treated as a loss under the tax system of the country where the transferor resides or treated as an income under the tax system of the country where the transferee resides. Under these conditions, it would not be rational to establish a contingent payment mechanism, and it would be more reasonable to establish a fixed sales price based on certain assumptions.

- If Option 1 were to be adopted and implemented, a mutual consultation process should be established so that price adjustments undertaken by a tax authority is recognized by the tax authority of the counterparty country.
Option 2: Independent investor

- In the example provided under Option 2, the income attributable to a company with no investment risk management functions reverts to the parent company. However, it is unclear what specific type of transaction is being considered and what specific tax treatment is intended from the perspective of transfer pricing.

- An MNE group may choose to set up an investment entity for its business investments from various perspectives such as centralized investment management, insulation from legal risks pertaining to the investment, and re-investment strategies. If the intent of this option is to revert the dividends and business income attributable to the investment entity to the parent company, this would constitute taxation that overrides the legal relations implicit in the investment through shares and payment of dividends based on shareholder resolution. This clearly deviates from transfer pricing theory and such taxation is unacceptable.

Option 3: Thick capitalization

- In relation to rules limiting interest deductions, paragraph 226 of Action 4 states, “both Action 4 and Action 9 seek to ensure that taxable profits are matched with economic activity giving rise to value creation.” Because the system would be extremely complex depending on the approach taken in adopting each Action, the first step should be to ensure proper consistency with Action 4.

- We have concerns over the consistency with the thin capitalization rule and the risk of double taxation (For example, consider a case where the maximum ratio for thick capitalization is set at a level that is lower than the maximum ratio for thin capitalization.)

- The cost of compliance with regard to adopting a new rule should be considered.

- Raising the capital ratio is necessary for maintaining a sound financial foundation. Hence, the thick capitalization rule is inappropriate as it provides an incentive for undermining financial soundness.

Option 4: Minimal functional entity
Among the thresholds for the application of minimal functional entity, judgment on “functional capacity to create value” plays an important role in the determination of qualitative attributes. However, value creation can take various forms in the business activities of a MNE. Therefore, there is no option other than to make judgments on a case-by-case basis.

The quantitative attributes appear overly formal, such that the contributions of an entity engaged in substantive activities could be underestimated. This is particularly true for the number of employees because the appropriate number of employees varies among industries, and the judgment should not be based on uniform criteria.

For both qualitative and quantitative attributes, the final judgment would be left to tax authorities. Because double taxation may result from a difference of opinion between tax authorities, the tax authorities should engage in prior consultation.

Option 4 specifies that an entity falling beneath the thresholds would be required to reallocate its profits based on a pre-determined factor. However, it is unclear how and by whom this factor is to be determined. Detailed guidelines must be provided on this matter because it is important to maintain consensus among countries on the calculation of this factor.

Option 5: Ensuring appropriate taxation of excess returns

When a CFC is engaged in positive substantive business activities in the country of its residence, its income should be included in Local Income regardless of wherever it accrues.

We support that the trigger tax rate is defined as the average effective tax rate over the preceding three years, on the grounds that determinations based on a single year may lead to the application of the CFC rule by one-off tax-exempt income.

When CFC taxation is to be applied, measures must be taken to prevent double taxation of the same income in two jurisdictions. For example, assume that a parent company residing in Country A, which is not a low tax-rate country,
invests in Company C, which resides in a low tax-rate country, through a subsidiary in Country B, which is not a low tax-rate country. Under the primary rule of Option 5, the income earned by Company C may be subjected to CFC taxation in both Country A and Country B. A solution should be proposed to limit the right of taxation to either Country A or Country B; or to otherwise eliminate double taxation.
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Yuasa Trading Co., Ltd.
Some Comments on BEPS Actions 8 9 and 10: Discussion Draft on Revisions to Chapter 1 of the Transfer pricing Guidelines.

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This submission relates to the Discussion Draft on Revisions to chapter 1 of the Transfer pricing Guidelines. The submission argues that current international norms relating to transfer pricing rules are inappropriate and have resulted in a large increase in tax avoidance strategies. Google is used as an example. The submission argues that a key distinction should be made between risk where the probability distribution of outcomes is known, and uncertainty where it is not known. Current and proposed transfer pricing rules which consider that all investments can be considered as subject to risk, leaves open the possibility of abusive transfer pricing.

(1) Transfer Pricing and Tax Avoidance

Switching profits via transfer pricing has long been recognised as a key part of tax avoidance strategies\(^1\). One of the main reasons transfer pricing issues are so prominent in tax avoidance strategies is because of internationally accepted norms encompassed in OECD transfer pricing rules.

The OECD (2010, par 1.8) state:-

“There are several reasons why OECD member countries and other countries have adopted the arm’s length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for members of MNE groups and independent enterprises. Because the arm’s length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment”.

Many would not share this view. Kleinbard (2011a), for example, argues current transfer pricing rules:-

(1) Ensure relative freedom with which a parent may have dealings “with a subsidiary as if it were an independent actor”;

(2) Grant the ability to treat a “subsidiary’s capital (furnished by the parent) as if that capital were separate from the parent’s assets” in measuring business risks undertaken by the subsidiary and hence the share of income attributable to the subsidiary;

(3) Enable assets such as Intellectual Property, to be located in low tax countries without any examination of the rationale for doing so (Kleinbard, 2011, pp. 703-704).

\(^1\) See for example Stewart 1989.
Even though commonly controlled and part of an integrated business strategy, transactions between subsidiaries are tested using current [OECD] transfer pricing rules as if the same transactions were undertaken between unrelated entities.

Vann argues current transfer pricing practice is based on “inappropriate market analogies which ignore the theory of the firm” and encourage “limits on intragroup contractual freedoms and the wider use of profit split methods” (cited in Kleinbard, 2011b, footnote 134).

Kay (2012) comments that the rational for all MNE’s is that businesses are not independent. Kay in discussing the U.K. Starbucks case, states the hypothetical question required of comparability analysis is as follows:- “Suppose the different geographic operations of a global corporation were independent businesses, what would then be the profitability of the independent businesses? Kay states “it is only necessary to ask this question of Starbucks to see why the arm’s length principle can never work”.

Rather Kay argues the profitability of MNE’s comes from economies of scale and scope which cannot be captured by an independent firm.

Kleibard argues all multinational firms have an advantage over purely domestic firms in their ability to develop stateless income, of which the “Double Irish Dutch Sandwich” tax strategy of Google is described as the main example (Kleinbard, 2011, pp. 706-713). The Google case is a useful illustration of how current transfer pricing rules enable the separation of value added and location of profits.

(2) Google and transfer pricing

Google’s operations in Ireland are central to Google’s non-U.S. operations and are the best known example of a ‘double Irish’ tax strategy, which relies extensively on using transfer pricing to switch profits to Ireland to benefit from Ireland’s very favorable corporate tax regime.

Google has substantial operations in the U.K., employing 1500 (Public Accounts Committee, 2012, Q.461) and generated $18 billion in sales (13% of global sales) in the period 2006-2011 (Q. 201, 2013). Yet just $16 million was paid in UK corporation taxes in this period. The Public Accounts Committee concluded (2013, p. 5):-

“Google defends its tax position by claiming that its sales of advertising space to UK clients take place in Ireland—an argument which we find deeply unconvincing on the basis of evidence that, despite sales being billed from Ireland, most sales revenue is generated by staff in the UK. It is quite clear to us that sales to UK clients are the primary purpose, responsibility and result of its UK operation, and that the processing of sales through Google Ireland has no purpose other than to avoid UK corporation tax”.

Other countries have made similar complaints.

A Google subsidiary in Ireland (Google Ireland Ltd.) accounts for 92% of Google sales outside the U.S. Google Ireland sales amounted to €15.023 billion and €12.457 billion for 2012 and 2011 respectively, but resulted in a pre-tax profit of €153 million for 2012 and €24 million for 2011, largely due to payments which are not explained in the annul accounts, referred to as “administrative expenses” of
€10.9 billion and €9.02 billion respectively. This is likely to be royalty payments paid to its parent, Google Ireland Holdings, which is registered in Ireland but “administered from Bermuda” (Public Accounts Committee, 2012, Q. 475). The address of Google Ireland Holdings is given as c/o Google Bermuda Ltd. Clarendon House, 2 Church St. Bermuda, the same address as law firm, Conyers, Dill and Pearman.\(^3\)

Google has been widely described as transferring royalty payments to a Dutch affiliate before transferring them to Bermuda - the Dutch Sandwich (Kleinbard, 2011a, pp. 706-713). In 2010 a ‘practice statement’ was issued by the Irish tax authorities which allowed royalties to be paid by an Irish tax resident company to a foreign company without deducting withholding taxes. Hence it is no longer necessary to route royalty payments from Ireland to Bermuda via the Netherlands.

There are considerable implications for group tax payments given that Google locates most of its non-U.S. income in Ireland.

Google (Form 10K December, 2013, p. 81) states:-

“Although we file U.S. federal, U.S. state, and foreign tax returns, our two major tax jurisdictions are the U.S. and Ireland” and “Substantially all of the income from foreign operations was earned by an Irish subsidiary” (Google Form 10K, 2013, p. 81).

The Google case demonstrates the ability of MNE’s to use current transfer pricing guidelines to engage in aggressive tax avoidance strategies.

(3) The European Commission Transfer Pricing Cases.

The narrow parameters within which transfer pricing rules must be examined are also illustrated by the recent cases taken by the European Commission.

The European Commission has undertaken investigations and published initial conclusions in relation to revenue authorities tax rulings on transfer pricing arrangements for Apple Computer operating in Ireland, Starbucks operating in the Netherlands, Fiat operating in Luxembourg, and Amazon operating in Luxembourg (European Commission press release, June 11, 2014). The investigations are being conducted by the Directorate General for Competition on the basis that tax rulings have resulted in granting “selective tax advantages” which constitute state aid (Almunia, 2014). In all four cases the Commission formed a preliminary view that illegal State aid was granted and announced a formal investigation\(^3\).

While preliminary findings indicate that there has been a breach of State aid rules, the governments of all four countries have issued similar statements to the effect that they expect to be exonerated. For example in relation to Starbucks the Dutch Deputy Finance Minister is quoted as stating “I am confident that this investigation will ultimately show that no state aid has been provided”. In

\(^3\) Source: Form B1 of Google Ireland Holdings filed at Companies Registration Office, Dublin

relation to Apple the Irish Minister for Finance stated that “Ireland is confident that there is no state aid rule breach in this case”. Even though Ireland would benefit from any tax payments the Minister also stated that “we will defend all aspects vigorously”.

Given the narrow parameters within which transfer pricing rules are decided, in particular the emphasis on comparable arm’s length pricing, the optimism of the four Governments that no case will be found against them is not without justification.

However in giving their conclusions, the Commission note that in all four cases the “different methods explained in the OECD Guidelines can result in a wide range of outcomes as regards the amount of the taxable basis”. The Commission comment that “when accepting a calculation method of the taxable basis proposed by the taxpayer, the tax authorities should compare that method to the prudent behaviour of a hypothetical market operator, which would require a market conform remuneration of a subsidiary or a branch, which reflect normal conditions of competition”.

There is considerable emphasis in the European Commission analysis of Transfer Pricing Reports on comparability and risk and return. The assumption is that the higher the risk the higher the profit.

(4) The Discussion Draft on Transfer Pricing

The OECD Discussion Draft on Transfer Pricing (OECD, 2014a), emphasises “contractual terms (par. 2); “actual conduct” (par. 3), and “comparability factors” (par. 10). However “arms length transactions” are recommended. Par. 84 states:- “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”.

As noted earlier in this submission identifying “arms length transactions” may both be impossible and inappropriate in particular in the case of MNE’s operating in sectors that are highly concentrated and I.P. intensive.

One issue identified in the proposed guidelines in transfer pricing analysis is how to account for risk. The discussion draft states (par. 36) that “Identifying the risks included in commercial or financial relations is a critical part of a transfer pricing analysis”, at the same time it is recognised that risks may be hard to identify (par. 38).

In this context the draft equates risk with uncertainty, for example par. 42 states:-
“Risks can be categorised in various ways, but a relevant framework in a transfer pricing analysis is to consider the sources of uncertainty which give rise to risk”.

Par. 48 states:-
“Determining the impact of risk and the significance of how risk and uncertainty may affect a transfer price depends on the broader functional analysis of how value is created by the MNE”.

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For Apple and Ireland see Department of Finance Press Release 11th June 2014; For Starbucks see Alex Barker and Vanessa Houlder, “EU Confronts Netherlands over Starbucks deal”, Financial Times November 14, 2014; For Amazon see Vanessa Houlder, Duncan Robinson and Alex Barker in Brussels, “Amazon probe steps up pressure over tax deals”; For Fiat see Financial Times, October 7 2014; Alex Barker and Vanessa Houlder, “Brussels probes Luxembourg over tax deal for Fiat”, Financial Times September 20, 2014; For Apple see Department of Finance Press Release 11th June 2014.
The difference between risk and uncertainty is important. Financial models, as in the discussion on a risk-return trade off (OECD, 2014, p. 14) and the use of the Capital Asset Pricing Model to identify risk in transfer pricing reports, as in the European Commission investigation of FTT (a Fiat subsidiary) and Luxembourg, assume risk – that is the probability distribution of outcomes is known. One of the reasons for the most recent general financial collapse was the assumption that risk (in particular that described by the normal distribution) in financial models extended to real world financial markets.

Similarly in most commercial investment decisions the investment decision is characterised by uncertainty that is where the probability distribution of outcomes is not known. It is possible however within an MNE that commercial activities could be artificially constructed so that the investment could be described as being one of risk, but the level of risk may be predetermined by contract and is thus wholly artificial. Furthermore given group wide guarantees for example, in relation to borrowing, other liabilities and on contract delivery, the concept of uncertainty for an affiliate cannot be separated from the group as a whole.

One implication is that in normal commercial transactions “risk-return tradeoffs” (BEPS Actions 8,9 and 10: Discussion Draft pp. 14-15) cannot be predicted, and cannot be used as a justification for actual profit levels. This leaves open the possibility that levels of ‘risk’ in an affiliate may be artificially increased or reduced via appropriate adjustments for ‘risk’ thus facilitating tax reduction strategies amongst group companies.

It is also the case that many MNE’s operate in markets where competition is limited because, for example, of patents, or where there is a dominant market position because of organisational capability, as in the case of Apple (Lazonick et al, 2013). Under these circumstances it is possible that most revenue streams may be allocated to affiliates within a group, whose returns can be characterised as being subject to risk, that is subject to known probabilities.

Current revised OECD rules do not address these issues. The proposals in the discussion draft on transfer pricing thus fail to “reconcile the location where profits are reported for tax purposes with economic activities and value creation, without increasing uncertainty” (OECD, 2014b, p. 7). They also largely fail the stated aim of reducing “aggressive tax planning”, (OECD, 2014c, p. 25).

Kay comments that the OECD position is that “the practical difficulties of the arm’s length principle are outweighed by its theoretical soundness. The reality is that these practical difficulties arise from its theoretical weakness”.

For these and other reasons the discussion draft (BEPS Actions 8,9 and 10: Discussion Draft, Part II) recognises that special measures are needed to counter BEPS risks. For example rules relating to a minimal functioning entity (option 4). However a mandatory profit split is likely to be more appropriate than reallocation to the immediate parent. Relying on a mandatory profit split may however be difficult to reach agreement on between differing tax jurisdictions requiring considerable inter-country dispute resolution. Hence simpler rules relating to requirements for ‘substantial activities’ to qualify for Permanent Establishment may be more appropriate.

It is also not clear how conflicts between ‘normal transfer pricing rules’ and ‘special measures’ may be resolved for example in relation to inappropriate returns for providing capital. Ambiguities and BEPS opportunities may arise because differing countries interpret similar rules in different ways.
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TO: ANDREW HICKMAN  
Head of the Transfer Pricing Unit  
Centre for Tax Policy and Administration, OECD

SUBJECT: Observations to the OECD Discussion Draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterization and special measures).

Dear Mr. Hickman,

Firstly we would like to thank the opportunity to share our thoughts regarding the OECD Discussion Draft on revisions to Chapter I of the Transfer Pricing Guidelines, including risk, recharacterization and special measures (hereinafter: Discussion Draft) released on December 19th, 2014. The Discussion Draft, which refers to the revision of Chapter I of the Transfer Pricing Guidelines (hereinafter: TPG), is probably the most important one released under the auspices of the BEPS process in transfer pricing matters as it entails the core aspects of the arm’s length principle (hereinafter ALP) itself and its implementation.

Following the structure posed in the discussion draft, our first set of observations will be referred to general aspects of the ALP and the function of the TPG as a relevant tool to interpret transfer pricing (hereinafter TP) regimes based on this standard. Second, we will pose observations related to the functional analysis that will serve to accurately delineate the transaction, an aspect that will be critical to correctly develop a comparability analysis. Third, we will briefly address whether the guidance of risks should be considered as amounting to a recharacterization issue. Fourth, we will analyze certain aspects of the new guidelines concerning the disregard of transactions as structured by related parties.

Our aim is to provide thoughts in the form of observations both to encourage discussion and to discover certain relevant issues that the drafters might take into consideration when revising their work in future revisions of the Discussion Draft.
General aspects related to the arm’s length principle.

Our first remark refers to the relevance of the guidance contained in the Discussion Draft as a document that will apparently be end up incorporated in the TPG. Both instruments may be used to interpret the ALP and are certainly helpful in the difficult task of implementing this rule into real life situations, both in DTC and domestic scenarios.

Nonetheless, it is relevant to distinguish between the ALP as drafted in art.9 of the OECD Model Tax Convention (OECD-MC hereinafter) –the rule in which the TPG base its guidance- and the ALP as embedded in domestic TP rules, because their formulation may differ. Please consider by way of illustration that art.9 OECD-MC departs from the “commercial or financial relations” parameter while the Spanish TP rule –among others- refers to “transactions between related parties” instead of “relations”. This distinction may be relevant for example in situations in which a transaction has not occurred albeit an entity benefits from the activity developed by another group member. A “commercial or financial relation” may exist in these cases, but not a “transaction” and thus in the framework of the Spanish TP rule no adjustment could be made.

Despite this, the Discussion Draft asserts that, when the outcome of commercial and financial relations result in a transfer of value between related parties, then a transaction has occurred –see paragraphs 3, 7, 8-. Nonetheless, it does not seem plausible to identify these three concepts as being interchangeable, namely the terms “transfer of value”, “commercial or financial relations” and “transactions” cannot be regarded as amount to the same reality. This second term is broader than the latter one, i.e. a transaction is a commercial or financial relation, but not all commercial or financial relations should be regarded as transactions. This rationale applies not only to controlled transactions but also to uncontrolled ones because a transfer of value may occur between two unrelated parties without the existence of a transaction.

Please consider that the example set in paragraph 4 of the Discussion Draft, in which a subsidiary benefits from certain marketing activities developed by its parent company in the absence of an agreement in that regard, does not necessarily amount to a transaction, unless the Discussion Draft uses this term in an extremely broad sense. The promotion of the branded product by the parent company may result in a more beneficial position for the subsidiary, as it will likely sell more products to independent retailers, but at the same time the parent company will achieve better results derived from an increase of the value of its trademarks. Both companies benefit from the marketing activities performed by the parent company and thus “commercial or financial relations” may arise, but it is highly doubtful that a transaction occurs in this case.

Anyhow, we encourage the authors of the Discussion Draft to take into consideration this kind of nuances, as may be relevant to correctly use this document or the TPG themselves as instruments to interpret TP domestic rules, avoiding legal conflicts.
Our second remark refers to the nature of the ALP itself. It has been noticed by a vast literature that the ALP is a parameter that may not properly fit in a globalized economy in which multinational enterprises (hereinafter MNEs) operate in an integrated and borderless fashion, as there are transactions exclusively undertaken by related entities which may be designed in a certain manner due to non-tax motivated economic reasons. That said, the ALP is still the most used parameter to allocate profits within MNEs members, as reflected in TP regulations from countries all around the world.

The interpretation of a rule should not be assessed from a policy or de lege ferenda perspective, but from the analysis of the construction of the rule itself. In this sense, it remains quite clear that a TP rule based on the ALP require a reallocation of benefits obtained by related parties taking into account what independent parties would have done. Thus, it is virtually impossible that transactions exclusively undertaken by MNEs –and hence transactions that independent parties would not undertake- may respect the ALP. Stating the contrary would imply to go beyond the possible meaning of the rule which at the end of the day amounts to its infringement.

Taking all these considerations into account, the following statement (embedded in paragraph 82 of the Discussion Draft) may be inappropriate “[…] the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm’s length arrangement”. This seems to imply a direct contradiction with the nature of the ALP itself and thus we would like to raise the issue before the drafters to be further discussed and clarified in further revisions of the Discussion Draft.

**Identifying the commercial or financial relations.**

The delineation of the transaction as structured by related parties is a critical step, as the result of this process will influence the entire comparability analysis. The efforts undertaken by the OECD to try to provide new insights in this area are to be applauded. Notwithstanding, further clarifications on certain topics would be welcomed, as the impact of the following issues is relevant to correctly assess a proper identification of the transaction at hand.

First, we consider that certain guidance regarding the interaction between the process of identifying and delineating commercial or financial transactions with GAARs, SAARs, sham or qualification rules should be developed to properly understand the role to be played by each one of these rules in the aforementioned process.

Second, the reference to economically relevant characteristics as an instrument to accurately delineate the transaction should not be confused to some sort of substance over form perception within the task of identifying the controlled transaction under analysis. We recommend the inclusion of a statement apropos this idea to avoid possible misunderstandings on the definition of
the term and its role in the performance of a comparability analysis. In this sense, we celebrate the proposed removal of a substance over form approach in the recharacterization of controlled transactions guidance put forward in paragraphs 83 et seq. of the Discussion Draft. Following this line of reasoning, a relocation of this parameter, i.e. its implicit inclusion in the section referred to the identification of the controlled transaction should not be accepted, and we encourage the OECD to state so in further revisions of the Discussion Draft.

Third, in line with the aforesaid, it remains somewhat unclear why the Discussion Draft resort to a parameter which is present in the recharacterization guidance of the TPG, namely the “options realistically available” one, in the section referred to the delineation of the actual transaction undertaken between related parties. This criterion, as used in TPG paragraph 1.65 can be considered as inherently flawed: if the absence of comparables is the point of departure for a recharacterization to be legitimate and appropriate then its result –the recharacterized transaction- will be always a realistically available option against the controlled transaction, which will never meet this criterion because of an absence of comparables, i.e. the controlled transaction is not even an “option” for unrelated parties to be undertaken.

All in all, the resort to the “options realistically available” criterion may be sensible if employed in scenarios in which the transaction have to be deduced from the conduct of the parties, as various options to delineate the transaction may arise. Notwithstanding, further clarifications in this topic would be useful to understand the intention of the drafters in this regard.

Risks.

Although the guidance on risks poses several technical issues that are quite controversial, we prefer to focus our attention in its position within the structure of the Discussion Draft and the TPG themselves, namely to label its role as a tool to correctly delineate the transaction or a pure recharacterization of the controlled transaction. Cases in which a contractual allocation of risk can be found between the parties but a reallocation is regarded as plausible may qualify as part of the latter option.

Although the distinction may amount in principle to the same consequence –the reallocation of risks within the framework of a comparability analysis- the circumstances in which a recharacterization may be legitimate are described by the TPG and the Discussion Draft as “exceptional”, as opposed to the mere delineation of the transaction. Thus, should a reallocation of risks be considered as amounting to a recharacterization, a tax administration would in principle have a heavier burden of the proof in demonstrating that exceptional circumstances arise in a given case. As this issue seems to be quite relevant in the role that the guidance on risks may have, we suggest the OECD to provide insights in this regard.
Recharacterization.

The issue of the non-recognition of conditions present in a controlled transaction within TP rules is certainly a delicate matter. We totally agree with the OECD in the consideration of this kind of adjustments as “exceptional” ones, being the recognition of the controlled transaction a crucial point of departure to conduct a proper comparability analysis. We consider this exceptionality as being present both in the definition of the circumstances in which a recharacterization may be conducted and the result of the recharacterization itself:

On the one hand, the absence of comparables as a necessary requisite to assess a possible recharacterization is a sensible criterion in this regard, although it might be useful to complement this mention –as stated in paragraph 82 of the Discussion Draft- with a reference to comparability adjustments, as the latter may be useful to define a feasible comparable and thus avoid the non-recognition of the controlled transaction.

On the other hand, the result of the recharacterization should be assessed in a proportionate manner, i.e. the only elements of the controlled transaction that should be modified are those that will not be present in an uncontrolled transaction. To put it in other words, the recharacterization must aim to respect the elements of the transaction as structured by related parties as much as possible.

That said, a proper implementation of an exceptionality criterion should also be based in the implementation of specific burden of the proof guidance. From our perspective, if a recharacterization process is to be labeled as exceptional, a qualified burden of the proof should be required to the agent that attempts to use this measure, i.e. the tax administration. Hence, the proof required to conduct a non-recognition exercise should regard: (1) the absence of comparables, including the impossibility to conduct comparability adjustments (2) the identification of specific conditions that will not be present in similar uncontrolled transactions (3) the appropriateness of the proposed alternative transaction –namely, the result of the recharacterization process- vis-à-vis a proportionality standard.

We recommend a thorough development of guidance in these topics to be present in future revisions of the Discussion Draft.

Notwithstanding, we consider that the OECD has made a remarkable breakthrough in the area of non-recognition of controlled transactions by apparently abandoning the two “exceptional” circumstances posed in TPG paragraph 1.65 in favor of a more sound and balanced criterion, i.e. the reasonable expectation to enhance or protect the commercial or financial position on a risk-adjusted basis posed in paragraph 89 of the Discussion Draft. We consider this standard to be a solid one and recommend the OECD to develop further guidance on its practical implementation, as there may be certain borderline cases that may be complex to resolve. Please consider the following example: a business restructuring is conducted within an MNE and as a result, a full-fledged subsidiary is
converted into a toll manufacturer due to a decrease in its market share and an increment in costs that render its activity as non-profitable. Apparently, in the short term the business restructuring process may leave the subsidiary in a worst position, but in the long run the restructuring is to be regarded as necessary for the subsidiary to adapt its size to new market circumstances. In this case, it is hardly understandable how a non-recognition of the restructuring process could be justified for TP purposes.

Last but not least, we would like to offer some considerations concerning the example present in paragraphs 90-91 of the Discussion Draft. Unlike the Discussion Draft, we consider that S1 does have an opportunity to enhance or protect its commercial or financial position through the transaction -specially the latter-, because after the transaction occurs, it has $400 million in cash to improve its activity without the need to get rid of product sales using the trademark as S2 has granted S1 a license to use the intangible. S2, on the other hand, can economically exploit the intangible with the assistance of the company that has developed it and earn income derived by this activity. Indeed, this transaction seems to have the attributes of a sale and lease-back one, which is quite common between unrelated parties to gain liquidity without refraining from the use of the good at hand.

Notwithstanding, we also consider that the mentioned example is flawed with some sort of abuse considerations, which amount to be one of the main burdens in a correct interpretation of the ALP. Although TP rules may prevent abusive transactions to benefit from unintended tax savings by adjusting benefits with reference to the benefits independent parties would have obtained in the same circumstances, this kind of regulations normally do not incorporate antiabuse-like references. Moreover, TP regulations usually amount to a high technical level analysis that is quite complex to be undertaken and should not be altered with external considerations regarding circumstances alien to the pure comparison between controlled and uncontrolled transactions.

In addition, it seems that the proposed solution to the mentioned example is to totally disregard the transaction, i.e. to consider that the transaction has never taken place between the parties –see paragraph 91 in fine-. We would like to pose certain questions it what regards the consequences of maintaining that position, i.e. should the revenue obtained by S2 derived from the exploitation of the intangible be attributed to S1? If yes, would be relevant to consider that S1 may have earned more revenue than S2 in exploiting the intangible? Could S1 deduct expenses in this regard? Should notional revenue be attributed to S1 in further fiscal years derived from a deemed exploitation of the intangible? If S2 sells the intangible from a private law perspective, should be considered this sale as undertaken by S1? If yes, should capital gains or losses be regarded as obtained by S1?.

It seems that further clarifications of the issue are needed and we encourage the OECD to include proper guidance in further revisions of the Discussion Draft.
Sincerely yours,

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1. Basic Stance on Transfer Pricing Taxation

Base erosion and profit shifting (“BEPS”) has become an issue in the global community primarily because of some multinational enterprises (“MNEs”) having managed to avoid transfer pricing taxation. Given this background, it is understandable why it has been argued that, in the course of the BEPS Project, the transfer pricing tax regime needs to be reviewed as well. Also, matters such as the treatment of intangibles have been long requested to be clarified, whether involving BEPS or not. Keidanren therefore supports the OECD’s effort to improve the transfer pricing tax regime.

The countermeasures to be taken, though, need to be reasonable and targeted. In recent years, Japanese companies have faced aggressive transfer pricing tax enforcement in a number of countries. Transfer pricing taxation poses a major obstacle to the international development of businesses, because the resultant amount of reassessed tax tends to be extremely large, requiring enormous efforts and costs to resolve disputes; and, even then, double taxation remains unrelieved in some cases. The BEPS Project should not result in an increase of transfer pricing tax disputes. We strongly hope that the transfer pricing tax regime and its enforcement will be harmonized among OECD countries and non-OECD G20 countries.

The Japanese business community emphasizes the particular importance of the following three points:

The first is a reaffirmation of the significance of transfer pricing documentation pursuant to BEPS Action 13. The recommendations released last September essentially
mean that MNEs will be required to prepare master files and country-by-country reports on top of local files. Ideally speaking, risk assessment should be carried out, not by imposing regulations like this, but through cooperative dialogue between taxpayers and tax administrations. Nevertheless, now that the recommendations have been issued, it may be important for MNEs to view them, in spite of compliance costs most certainly rising, in a positive light as an opportunity to reevaluate their global transfer pricing policies, create an information-sharing framework between the parent company and its subsidiaries, and take other proactive measures.

Such efforts on the side of taxpayers must be rewarded. Since the transfer pricing documentation package is expected to be shared, relevant tax administrations in respective countries should not stress more than necessary information asymmetries between themselves and taxpayers. They also should respect, to the maximum extent possible, the judgments made by companies about the content of documentation.

Secondly, emphasis needs to be placed on form rather than on substance. This relates to the first point as well. Recently, OECD’s discussions on transfer pricing taxation have the tendency that, although starting with an analysis of form such as legal ownership and contractual terms, the ultimate emphasis seems to be placed on substance, such as the actual conduct of the parties in the transaction. This tendency is seen in last year’s interim guidance on intangibles related to Action 8 and in the treatment of risks in the public discussion draft under discussion herein. The approach of treating form with excessive skepticism seems odd to the vast majority of taxpayers who have nothing to do with BEPS.

It is quite rare that ordinary taxpayers artificially separate the place where intangibles are legally owned from the place where value is created. It is also inconceivable for them to allocate risks in a manner inconsistent with the relevant contract. Furthermore, given that each MNE is expected to explain its global transfer pricing policy in the master file, the content of individual contracts concerning controlled transactions will be consistent with the contents explained in the master file. It needs to be recognized that form and substance are approaching each other rather than diverging.

In this circumstance, an approach that makes light of form in the name of making much of substance could lead to subjective interpretation and arbitrary application of the rule, thereby causing uncertainty for taxpayers. Attention should be paid to these points once again when revising Chapters I (The Arm’s Length Principle) and VI (Special Considerations for Intangible Property) of the Transfer Pricing Guidelines.

Thirdly, the arm’s length principle should be retained. The public discussion draft makes bold proposals on specific revision options. Those proposals, while the
reservation being made that a conclusion has yet to be reached, appear to be a harbinger of a paradigm shift in the transfer pricing tax regime. It is true that some point out the limitation of the current regime in the light of such trends as the increasing complexity of MNEs’ global supply chains, the greater role of intangibles in international transactions, and the outrageous tax planning of some taxpayers. Nonetheless, the arm’s length principle, which the OECD has long maintained and member countries have respected, should not be abandoned easily. We do not consider it appropriate to introduce non-recognition, to adopt special measures, and to allow an unconditional application of the transactional profit split method. Very careful consideration should be given to these matters.

Based on such basic stance, our comments on specific issues are as set out below. We submit comments on the profit split method in a separate document.

2. Risk (Sections D.1 and D.2 of Chapter I)

Part I of this public discussion draft proposes revisions to Chapter I (The Arm’s Length Principle) of the Transfer Pricing Guidelines. In particular, revised Sections D.1 “Identifying the commercial or financial relations” and D.2 “Identifying risks in commercial or financial relations” go into greater detail on risks, including risk analysis frameworks and risk categorization. As these may help increase transparency in transfer pricing taxation, the overall direction seems appropriate. On the other hand, more detailed guidelines and more complex tax compliance can be said to be two sides of the same coin. In the course of finalizing revisions to the Guidelines, consideration should be given to ordinary taxpayers.

For instance, paragraph 5 of Section D.1 reads, “It should not be automatically assumed that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties.” As we pointed out earlier, it is not advisable to take the approach of making light of contracts from the start, given that the vast majority of taxpayers take compliance very seriously.

As to Section D.2, we are concerned about the statements in paragraph 46 that “assumption of core risks is likely to be rooted in a MNE group’s operational functions, and is not always limited to the party in which the outcome of the risk materializes,” and in paragraph 49 that “blanket statements that one or another party performing commercial activities is insulated from all commercial risk . . . should be carefully scrutinized.” These statements are true, but excessive if they are designed to require MNEs to undertake a detailed risk analysis of all the controlled transactions, regardless of importance. We also fear that the relevant countries may have different views as to where risk exists and where it is managed and controlled, causing new disputes between
Both tax administrations and taxpayers have only limited resources. Revisions to the Guidelines should be made in a manner that, at least, prevents the revised Guidelines from resulting in more rigorous investigations into ordinary taxpayers, a heavier administrative burden, and a greater number of disputes.

We find that in many parts of Sections D1. and D2., the discussion of risk is too general to apply to the insurance sector including reinsurance, where assumption and transfer of risk are the core of the business. We believe that the insurance sector should be distinguished from other sectors. Paragraph 78 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)". However, in the insurance context, while an insurer generally does not control the risk sufficiently, it assumes risk in return for collecting a premium which is priced depending on the level of the risk assumed. Risk assumption is the core business of the insurance industry, and as such, the insurer would therefore be entitled to unanticipated profits or required to prepare for unanticipated losses.

Due attention needs to be paid to issues specific to the insurance sector, whose operation is regulated and supervised in each jurisdiction, such as the relationship between risk and capital.

3. Non-recognition (Sections D.3 and D.4 of Chapter I)

Even after a transaction has been carefully examined through the process pursuant to Sections D.1 and D.2 of Chapter I, the provisions of Sections D.3 and D.4 require the possible non-recognition of the transaction to be considered on the grounds that “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 recognized for transfer pricing purposes” as set out in paragraph 82.

Paragraph 89 defines an arrangement exhibiting fundamental economic attributes as one that “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.” The paragraph continues, “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 recognized for transfer pricing purposes.” With regard to consequences of non-recognition, paragraph 93 reads, “The structure that
replaces the taxpayer’s structure for transfer pricing purposes should be determined by the 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.”

The notion of “fundamental economic attributes” is explained to replace the commercial rationality test hitherto used (paragraph 88). However, the conditions triggering non-recognition are still unclear, which could lead to subjective interpretation and arbitrary application of the rule by tax administrations. This notion, simply put, means that transactions that economically do not make sense are not recognized for transfer pricing purposes, and has the effect of forcing enterprises to adjust the behavior itself, rather than the price, of controlled transactions. We cannot support the provisions of non-recognition that lacks clarity. It is necessary, at the very least, to clarify that replacing the term “recharacterisation” used in the existing Guidelines with the term “non-recognition” proposed in the public discussion draft will not cause cases of non-recognition to increase, in other words, that Sections D.3 and D.4 will never apply to ordinary taxpayers. Detailed guidance on the difference between "fundamental economic attributes" and "commercial rationality", and outcome of the consequences of non-recognition (D.4) would be helpful.

4. Special Measures

Part II of the public discussion draft states that “the main aim of the Transfer Pricing Actions (8–10) is to assure that transfer pricing outcomes are in line with value creation” in paragraph 1, and that “the proposed revisions set out in Part I . . . are intended to make significant contributions to achieving this aim” in paragraph 2. Then, paragraph 3 reads, “However . . . 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.” Based on these views, Part II proposes five potential special measures.

However, as we pointed out earlier, now that MNEs are expected to share their master files and country-by-country reports with relevant tax administrations, continuing to stress information asymmetries faced by tax administrations is not balanced. Moreover, as non-recognition provided for in revised Section D.4 of Chapter I of the Transfer Pricing Guidelines is likely to function as a kind of special measure, there is no need to add other special measures that would overlap with it. While tax avoidance cases these
special measures are intended to address are considered to include the assignment of a trademark to an entity in a low-tax country described in paragraphs 90 and 91 of Part I of the public discussion draft, we suppose that only a handful of enterprises undertake such extreme tax planning. Countries should not subject ordinary taxpayers to unstable taxation by focusing too much on deterring abusive schemes.

Paragraph 6 of the public discussion draft states to the effect that it is not critical to determine whether a potential special measure is within or beyond the arm’s length principle because the aim is to consider the effectiveness of the measure. Still, if a special measure were to go beyond the arm’s length principle, questions would arise as to its consistency with Article 9 (Associated Enterprises), as well as with Article 25 (Mutual Agreement Procedure) in the event of it causing double taxation, of the OECD’s Model Convention.

In the current situation where translating other BEPS Actions into concrete rules alone is expected to increase disputes, the introduction of special measures would drive that trend further. In view of this, the Japanese business community consider special measures unnecessary, and strongly requests that, in the event of special measures having to be adopted, any double taxation resulting from their application be eliminated.

Our comments on individual options are as follows:

**Option 1: Hard-to-value intangibles**

Based on the so-called commensurate with income standard, the option permits an ex-ante price adjustment on the grounds of a rise in value within a certain period of time after the transaction, thereby seriously undermining taxpayers’ predictability. There is a gap between the information available to tax administrations for reassessment and the information available to taxpayers at the time of transactions. It is extremely dangerous for the OECD to recommend that the member countries use such a taxation tool that enables hindsight adjustments.

The public discussion draft states that a taxpayer may be able to rebut the tax administration’s presumption under certain conditions. However, it should be tax administrations that bear the burden of proving the inconsistency of taxpayers’ pricing with the arm’s length principle. Also, the use of the phrase “contemporaneously document” is unreasonable in that it imposes a burden on taxpayers.

Negative impact on ordinary taxpayers needs to be minimized because we understand that the main purpose of introducing special measures is to address BEPS. Although it seems that the current proposal aims to deal with all transfers of intangibles, the
following elements should be taken into account as additional conditions to trigger the application of the measure.

* A transferee of an intangible is located in low tax jurisdiction
* A transfer of an intangible in question occurred in the period pre-determined by the local legislation (e.g. a few/several years)

**Options 2 and 3: Inappropriate returns for providing capital**

What these options are intended to achieve is understandable only in the context of the example in paragraphs 90 and 91 of Part I, which we assume is the kind of case the options are designed to address. Yet, the options entail a practical issue as to whether it is possible to define “adequate capitalization” in the first place, along with the issue of consistency with Action 4 (Interest Deductions).

We also fear that these options may go beyond addressing those cases to establish a rule whereby thick capitalization itself is deemed problematic. If such a situation were to materialize, it would be deemed problematic that a manufacturer wishing to set up new overseas facilities simply establishes a subsidiary and takes an equity stake in it. Holding companies, regional or otherwise, might be subject to this special measure, too, on account of thick capitalization. Consideration should also be given to an impact on regulated financial services businesses.

**Option 4: Minimal functional entity**

The term “fundamental economic attributes” defined in Part I is used here once again. Clarity is needed as to the difference between this option and non-recognition.

Furthermore, while a mandatory profit split based on a predetermined factor is proposed as a way of reallocating profits of a minimal functional entity, we are not supportive of this method because it may lead to formulary apportionment. Applicability to collective investment vehicles is also questionable.

**Option 5: Ensuring appropriate taxation of excess returns**

This option entails the application of a controlled foreign corporation (“CFC”) rule to entities located in low-tax countries. Whereas unrelated to transfer pricing taxation, this option, generally speaking, may be instituted as a means of preventing tax avoidance if properly designed, such as by establishing exemption criteria applied to proactive business activities and by simplifying the calculation related to the threshold.

The problem, in our opinion, is that countries with strict CFC rules already in place will
hardly be motivated to additionally introduce this option. Utmost consideration should be given to the compliance burdens of taxpayers.

5. Closing

In the area of transfer pricing taxation, by around this spring, public discussion drafts are due to be released that deal with the treatment of cost sharing agreements and hard-to-value intangibles. The Japanese business community is strongly interested in what a revised transfer pricing tax regime will be like as a result of the BEPS Project. While we are fully aware of the necessity to prevent double non-taxation, what we taxpayers need are, simply, clear rules, transparency in enforcement, and the elimination of double taxation. We will continue to be constructively involved in discussions at the OECD.

Sincerely,

Subcommittee on Taxation
KEIDANREN
Professionals in the Global Transfer Pricing Services practice of KPMG welcome the opportunity to comment on the OECD’s Discussion Draft titled “BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization and Special Measures)” (“Discussion Draft”). KPMG commends the OECD for getting the business community involved on this important and challenging issue.

This document summarizes KPMG’s main comments. As requested by the OECD, we have attached a separate file that contain this summary and our detailed points.

KPMG appreciates the OECD’s need to revisit its guidance around the location of risk, and its impact upon the question of when tax authorities should have the right to recharacterize transactions as established by taxpayers. That said, KPMG has some fundamental concerns with the approach that the OECD has taken. The most serious of these concerns are as follows:

1) The Discussion Draft essentially ignores long standing tax policy as set forth in Articles 7 and 9, and appears to assume that multinational enterprises (“MNEs”) are free to allocate capital and its associated returns wherever they like without impacting anything other than income tax. However, the location of capital and its associated profits affects both other tax issues and business issues that have nothing to do with tax (e.g., local regulations that require that a local entity have sufficient capital to undertake its business).

2) The Discussion Draft seems to assume that the assumption of risk is inseparable from decision-making at all levels, and that the ownership of capital/assets has little or no impact upon the allocation of risk. This assumption is simply not consistent with observed arm’s length behavior.

3) The Discussion Draft actively encourages tax authorities to second-guess the contractual arrangements established by taxpayers by stating that they are “..at best…” the starting point in determining the “accurately delineated transaction.” This is recharacterization in substance, and will remove any common understanding of the relevant business arrangements. An increase in
the number and size of disputes can be expected, as well as an increase in the difficulty in finding a principled solution to those disputes. The OECD should develop more clearly articulated guidance that provides taxpayers with the information that they need to establish business arrangements that will be respected by tax authorities.

4) In its discussion of both “accurate delineation of transactions” and of identification of risk, the Discussion Draft suggests a universal approach to auditing taxpayer transfer pricing arrangements through an extremely detailed functional analysis that neither practical nor necessary for the vast majority of transactions. Further, the Discussion Draft is primarily concerned with issues previously addressed in connection with the release of Chapter IX. It is unclear why the transfer pricing issues in many of the examples provided in the Discussion Draft could not be addressed via an appropriate functional and comparability analysis under existing guidance. The OECD would substantially improve the ability of stakeholders to provide useful input by providing a clear upfront discussion of the concerns with respect to existing guidance, and in particular examples where that guidance is felt to be inadequate to prevent material distortions of taxable income.

KPMG believes that the OECD needs to start its recommendations around risk and recharacterization from the premise that the vast majority of the transactions that will be governed by its guidance are ones that are a necessary part of international business, and which do not involve harmful tax practices, but where double taxation is much more likely than double non-taxation. Therefore, the primary focus of its guidance should be to provide the separate legal entities within an MNE group with the correct amount of income per the broad parameters of Articles 7 and 9.

KPMG recognizes that the above approach may lead to cases in which controlled entities realize income that may not be taxed appropriately under OECD tax policy objectives, and that additional guidance is therefore needed to address any resulting double non-taxation. Such guidance, however, should be specifically targeted at that issue, and should not undermine taxpayers’ ability to comply with requirements in the numerous cases where the tax authorities involved in the transaction are taxing the income that is appropriately reported in their jurisdiction. While a limited amount of this targeted guidance may lead to some limitations on the application of the arm’s length principle by setting minimum substance requirements and/or establishing parameters around the amount of profits that can be shifted by “de-risking” local entities, this is primarily a question of determining what exceptions to the arm’s length principle should be made as a matter of tax policy rather than changing the arm’s length principle itself.

KPMG’s detailed comments are provided in a separate file.

About KPMG

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 162,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International
Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.
Comments on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization and Special Measures)

February 6, 2015

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

From KPMG

Date February 6, 2015

Ref Comments to the OECD:
BEPS Actions 8, 9 and 10 – Discussion Draft on the Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization and Special Measures)

cc Clark Chandler and Steve Blough, KPMG in the U.S.

Comments on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization and Special Measures)

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Comments on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization and Special Measures)

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KPMG believes that the OECD needs to start its recommendations around risk and recharacterization from the premise that the vast majority of the transactions that will be governed by its guidance are ones that are a necessary part of international business, and which do not involve harmful tax practices, but where double taxation is much more likely than double non-taxation. Therefore, the primary focus of its guidance should be to provide the separate legal entities within an MNE group with the correct amount of income per the broad parameters of Articles 7 and 9.

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Financial Services

The core functions of financial services involve the assumption, transfer and management of different types of risk – risk is effectively their stock in trade. Moreover, financial institutions necessarily transfer risk to achieve benefits of diversification and enable the effective management of those risks. For example, a bank may enter into thousands of interest rate derivatives with clients at any one point in time. Those risks are concentrated in particular trading books to allow for netting of positions so that only the net interest rate risk needs to be managed, thereby reducing the bank’s overall interest rate risk exposure and the need for scarce regulatory capital. If the interest rate derivative is in the money for the bank a credit risk exposure is created. That credit risk exposure will be transferred to another book where again a net credit position can be managed by traders with expertise in credit risk rather than interest rate risk. Likewise another example in the Insurance sector would be the reinsurance of risk from a local affiliate to a group headquarter company, which would be done to allow for more effective management by centralizing portfolio risks that in the aggregate is more diverse than would be written by an individual insurer on its own and allow for more efficient and effective use of capital.

Given the vast number of transactions transferring risk daily in financial services businesses, the requirement for the kind of detailed and subjective guidance before the risk transfer is respected that is delineated in the Discussion Draft would be simply impractical for both taxpayers and tax administrations. Additionally, the concern of the OECD that lies behind the new guidance on risk transfer is based on a perceived lack of divergence of interest between the parties to the risk transfer and the assumption that MNEs are free to allocate risk and capital within the MNE group at will. This concern is not well founded for financial services businesses, which because of the key role they play globally in assuming financial risks from the non-financial sector are subject to intense scrutiny from clients, investors and above all regulators as to how they subsequently manage that risk so that they are able to absorb losses from the realization of those assumed risks in a particular legal entity. That scrutiny and regulation provides a strong degree of protection for the tax authorities from inappropriate risk transfers that might lead to BEPS. Financial businesses need to centralize risk assumption and management to be capital efficient and to be able to meet potential losses from the risks assumed from the non-financial sector.

Therefore for the reasons stated above we recommend that the any revisions such as proposed in this Discussion Draft in respect of risk are explicitly stated not to apply to financial services businesses. If nevertheless the OECD is not prepared to accept this then we believe that very specific and practically implementable guidance should be drafted that applies to the financial services sector and reflects appropriately the specific circumstances of financial services businesses.

KPMG’s detailed comments are provided below, and are organized as follows:

- A discussion of the general problem along with appropriate objectives;
Comments on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization and Special Measures)
February 6, 2015

- An elaboration upon considerations related to the assumption of risk;
- A discussion of recharacterization;
- A discussion of special measures.

Overview of Key Issues

The OECD’s guidance around risk and recharacterization is clearly concerned with the BEPS policy objective of ensuring that profits cannot escape tax (e.g., to address the issue of double non-taxation). With respect to Actions 8, 9 and 10, we note two possible aspects of the OECD’s concern in this regard:

1. Double non-taxation\(^1\) may be *per se* inappropriate, for example resulting from unfair tax competition or tax rules which permit results not in accordance with widely agreed objectives;

2. Double non-taxation, combined with the mobility of capital and intangible rights, may give taxpayers an incentive to engage in abusive transfer pricing practices, i.e. transfer pricing that departs from the arm’s length standard such as to minimize the taxpayer’s income subject to tax.

The OECD appropriately seeks to issue guidance under Actions 8, 9 and 10 to address the second of these concerns. However, this guidance must also establish clear and administrable rules. Moreover, it is not appropriate that this guidance address the first concern through departures from the arm’s length standard, and the guidance should respect the provisions of Articles 7 and 9 of the Model Treaty. In this regard, Article 7 effectively states that one tax authority cannot tax the profits of a non-resident entity absent a permanent establishment (“PE”), while Article 9 states broadly that the profits of the legal entity should be equal to those that it would have earned, had it not been controlled. In combination, Articles 7 and 9 provide that each separate legal entity should earn the profits that would be expected at arm’s length, and that tax authorities (absent a PE) are not allowed to tax the profits of non-resident entities.

Meeting the objectives set forth above is clearly challenging. From an economic perspective, capital is mobile, and commands a positive risk-adjusted return at arm’s length. Such arm’s length returns generally do not depend upon the tax attributes of the legal entity that owns the capital – there is no reason to expect that the arm’s length return for capital that is taxed at a 0% rate is different from that which is taxed at a 25% rate. As a result, legal entities may earn profits that are consistent with those that would be earned at arm’s length return but which may not be subject to tax.

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\(^1\) For purposes of this discussion, double non-taxation may be considered to include taxation at very low rates.
We then turn to tax policy as set forth in the model treaty. Article 9 effectively requires that controlled parties should be respected as separate legal entities, and should earn arm’s length returns. There are good policy reasons for this from both a tax and business perspective. First, the tax treatment of income and expenses clearly depends upon a wide variety of tax rules imposed by the country of residence. For example, research and development (“R&D”) spending is a deductible expense that can offset profits from other businesses in the same legal entity but not other legal entities; the question of whether an R&D credit is available depends upon the tax rules of the jurisdiction that houses the legal entity, as do rules around loss carryforwards, dividend repatriation, withholding taxes, and treaty protection. In addition, there are often important non-tax business reasons for respecting the separate legal entity structure. As just one example, construction and engineering firms that secure large projects may set up a separate legal entity around a specific project either to comply with local requirements or to limit potential liability. Similarly, regulations in the financial services industry often impose capital requirements that depend upon respecting legal entity structure.

Article 9, therefore, requires that each separate legal entity earn an arm’s length profit regardless of the specific tax rules that apply to that legal entity. Once the profits of the separate legal entity are determined, Article 7 effectively states that, absent a PE, other tax regimes are not allowed to tax the profits of a non-resident. This places clear limits on the ability of a tax authority to tax income that is earned in a different tax jurisdiction.

**Approach Taken in Discussion Draft**

The Discussion Draft attempts to address this difficulty by linking capital and risk-taking to decision making. There are several fundamental problems with this approach.

First, key decision-making around risk can be made by decision-makers who are themselves mobile. Consider the example of a pharmaceutical company that is deciding whether to commit several hundreds of millions of Euros to fund a Phase III clinical study. That decision is basically a board-level decision that is made at a single point in time based on a review of a reasonably limited amount of information around the likelihood of success based on prior clinical trials and future projections. Once made, there may be a large number of future decisions regarding how the detailed clinical trials will be conducted, but they will not be the key determinant of future profits – that will depend upon the outcome of the clinical trials. The source of value is the decision and ability to put hundreds of millions of Euros at risk; value attributable to this should reflect an arm’s length return which should not vary based on whether this was done out of the headquarters company or a controlled foreign corporation (“CFC”); nor should it depend upon the tax attributes of either.
Second, even when decision-making cannot be separated from local functions and assets, it is often not possible to identify and document the contributions and relative importance of specific decisions or decision makers. Consider the simple case of a manufacturer of consumer products that is selling to a related distributor. Both the manufacturer and the distributor make decisions and put assets at risk. However, the relative importance of the decisions is hard to measure and may vary over time (e.g., the relative importance of design of a manufacturing line vs. the decision as to how to configure shelf space), and it is often difficult or impossible to determine who in fact made key decisions.

Unlike the existing guidance in Chapter III and Chapter IX, which provides actionable steps that taxpayers can take to ensure that their business arrangements will be respected, the Discussion Draft calls for an extensive analysis of decision making in order to determine the “accurately delineated transaction.” This analysis is likely to be very time consuming, both for taxpayers and tax authorities, and asks for information that will be difficult or impossible to verify objectively. Moreover, the purported linkage between risk and decision making is used to reduce the legal and contractual relationship between the parties to a mere “starting point” which may readily be disregarded and replaced by some other inferred transaction. Such replacement constitutes a recharacterization of the transaction under a different name. The level of profit that a controlled entity with substantial intercompany transaction would earn at arm’s length is dependent upon the specific business relationships that have been established up-front. Failure to respect the business arrangements as established by the taxpayer makes it difficult or impossible for a taxpayer to reliably determine its expected tax liability (and therefore to accurately self assess) and increases the likelihood that adjustments will be based on substitute structures that generate results that are favorable to specific tax jurisdictions. This in turn will lead to an increase in the likelihood of controversy, the magnitude of the amounts in dispute, and a reduction in the ability to resolve disputes on a principled basis.

Very notably, the guidance around the application of the arm’s length principle contained in the Discussion Draft applies to all transactions, without distinguishing abusive transactions from the vast majority of transactions that are routine and unexceptional in nature. The detailed analyses recommended in the Discussion Draft will therefore create an enormous resource burden on both taxpayers and tax authorities, is likely to be unadministrable, and will result in greatly expanded disputes and double taxation cases. Any final revisions to Chapter I should include substantial guidance, including examples, to assist both taxpayers and tax authorities in understanding circumstances where such analyses are likely to be important in avoiding material distortions in taxable income.

The last section of the Discussion Draft asks for comments on five “special measures” that are “either within or beyond the arm’s length principle.” While the Discussion Draft argues that there is no need to focus (at this point) on whether any of the special measures are on one side or the
other of this boundary, KPMG believes that it is very important to distinguish between guidance that is based on the arm’s length principle – which should be based on objective observations of third party behavior regardless of whether the resulting rules lead to tax results that are consistent with the OECD’s BEPS objectives – and measures which are explicitly designed to meet specific tax policy objectives. To do otherwise makes it very difficult to prevent policies that are specifically designed to prevent abuse (e.g., limiting the profits that can be realized by a low tax “mailbox” company with no substance) from also distorting perfectly valid business transactions (e.g., the need for expected profits that are several multiples of an initial R&D investments when that investment has less than a 50% chance of success.) Further, such distinction is essential to aligning the guidance with Articles 7 and 9.

**Suggested Alternative Approach**

KPMG believes that the OECD’s Guidance on risk and recharacterization should be based on the following principles.

First, the guidance should allow taxpayers to establish business arrangements up-front that have a high likelihood of being respected by the tax authorities. KPMG believes that the existing guidance contained in paragraph 1.65 and in Chapter IX are appropriate for this purpose. However, if the OECD decides to expand the situations in which tax authorities can disregard the contractual and business relationships established by taxpayers, the new guidance should provide clearly specified requirements which taxpayers can follow and which, if respected, will preclude such re-characterization. For example, if a commensurate with income test is applied to hard to value intangibles, the rules around that test should be spelled out in a way that will allow taxpayers to enter into business arrangements that will comply with such restrictions.

Second, the arm’s length principle should apply in the same way, regardless of the tax attributes of the legal entities involved. The arm’s length principle is the basis for determining the income of the legal entity under Article 9, and the accurate determination of income (and expenses) is important for the application of other tax rules, and often has important consequences other than income tax.

Third, the application of the arm’s length principle should be based on assumptions about the behavior and pricing of uncontrolled transactions/prices, which are ideally based on actual observations, but at least are not contradicted by available evidence. However, there are few references to the use of evidence from third party transactions in the Discussion Draft. To the extent that the OECD wishes to impose specific limitations that are driven by policy concerns rather than observed arm’s length behavior, these limitations should be spelled out clearly and should be ones that taxpayers can proactively accommodate. Two possible examples of such limitations might be:
1) Limiting the amount of risk that can be stripped out of a de-risked entity;

2) Imposing specific substance requirements on legal entities that incur substantial risks and/or which play a key role in the supply chain. Such substance requirements, however, should be ones that can be explicitly relied upon in establishing up-front contractual arrangements and which are consistent with the way in which MNEs manage their business (e.g., the decision-making around managing risk may be decentralized rather than located in a single legal entity.)

Fourth, if the OECD decides to impose limitations on the arm’s length principle based on the tax attributes of the legal entities involved, these limitations should be specifically targeted at specific tax results that are inconsistent with the OECD’s tax policy objectives, and should be delineated clearly so that taxpayers can react to them appropriately. In this regard, special measures that go beyond the arm’s length principle (e.g., which are inconsistent with the application of Article 9) are likely to be needed to address the BEPS policy concerns around double non-taxation. Such special measures should be:

1. Clearly identified as such, and not blurred into an arm’s length analysis;
2. Targeted as narrowly as possible at the tax results that are leading to the double non-taxation; and
3. Implemented through a tax on the profits that are captured by the special measure, and not lead to a reallocation of the underlying profits from one legal entity to another.

Risk

The OECD is properly concerned with understanding and providing guidance on the attribution of risk and the implications of such attribution on transfer prices. The OECD previously provided useful guidance on these matters with the release of Chapter IX on business restructurings. The guidance around risk contained in Chapter IX emphasized the need for a clear, up-front specification of responsibilities and risks, the provision of documentation that those responsibilities and risks were ones that would be expected at arm’s length, and then requiring that taxpayers behave in accordance with their up-front agreement.

This guidance provided a clear and administrable roadmap that could be used by taxpayers and tax authorities alike in determining which entities within a supply chain bear risk. While KPMG understands that some member states view that the Chapter IX guidance is inadequate and support an effort to supplement it through revisions to Chapter I, any such new guidance should also apply the same principles set forth above.
Comments on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recategorization and Special Measures)  
February 6, 2015

Identifying the Location of Decision Makers

The OECD Discussion Draft calls for a very detailed assessment of specific risks and the identification of the decision makers controlling such risks. In doing so, the Discussion Draft ignores the reality that it is typically very difficult, if not impossible, to isolate the outcome of individual risk factors much less link these outcomes to a specific decision-maker. Rather, actual business outcomes are the result of management’s anticipation of and response to a number of unforeseen developments (e.g., exchange rates change unexpectedly (foreign exchange risk) and transactions flows are changed accordingly which shifts volumes amongst plants (volume risk) which leads to wage pressures in certain plants (factor price risks) which cause the local selling company’s margins to fall as it cannot pass along price increases to customers (market risk), etc.).

This situation is further complicated by the fact that decision-making within a multi-national group is often spread throughout the group rather than concentrated in a single legal entity. Moreover, the location of specific decision makers is often very mobile. For example, the geographic / legal entity location of specific decision making roles can be very fluid within an MNE depending on need to respond to executive turnover and evolving business considerations.

The complex nature of decision-making within a multinational group makes it very difficult to trace the precise alignment of functional control over risk with its contractual attribution. This should not be used as an excuse for disregarding contractual arrangements as this would make the arm’s length principle unworkable. Instead, the application of the arm’s length principle for transfer pricing requires a practical approach that distinguishes those issues and circumstances that are material for the allocation of taxable income from those that could be of theoretical interest but are of no practical importance. For such reasons, while transfer pricing analyses generally talk about risk allocation and try to identify which risks are most economically relevant, they often look to margins and adjusted ranges (e.g., limited risk distributors (“LRDs”)) as a way to manage transfer prices, as opposed to separately accounting for each individual risk and its realization.

Timing of Decisions Around Risk

The Discussion Draft focuses almost exclusively upon determining who makes decisions regarding risk, while almost completely ignoring when such decisions are made. This is asking the wrong question for two reasons. First, as is discussed above, information on who makes decisions, at least in the detail that is suggested in the Discussion Draft, is likely to be both unknown and unknowable as an objective matter when tax authorities are conducting an audit several years after the decisions have been made. Decision making is often decentralized, is often an exercise in consensus building, and is not tracked in the normal course of business. Therefore, taxpayer and tax authority positions
are likely to be based on subjective interpretations of ambiguous information rather than objective data.

Information on when business arrangements are entered into and risk is assigned, however, can be documented objectively in intercompany arrangements, along with a contemporaneous explanation as to why these arrangements are consistent with those that would exist at arm’s length. This provides an objectively determinable basis for auditing whether the taxpayer was in compliance with the agreed upon arrangements, and whether the associated transfer pricing was consistent with arm’s length expectations.

Second, the ability to “game” the system in a way that leads to moral hazard (discussed below) is much more dependent upon the timing of when business arrangements and risk allocations are set than on who makes such decisions. If decisions on business arrangements and risk allocations are made on an up-front ex ante basis, it is very difficult to artificially pick and choose where successful and unsuccessful risk outcome will occur regardless of whether the decision maker is in the United States, France, China or even Malta. However, if decisions on business arrangements and risk allocations are made on an after-the-fact ex post basis, it is very easy to artificially pick and choose where successful and unsuccessful risk outcomes will occur, also regardless of whether the decision maker is in the United States, France, China or even Malta. This observation applies to tax authorities as well as taxpayers, and the ability to disregard business arrangements that have been established up-front makes it much more difficult to deal effectively with double taxation issues in the mutual agreement procedure (“MAP”) process.

**Separation of Risk From Decision Making:**

The Discussion Draft often takes the position that the assumption of risk is not separable from control over risk at arm’s length. This is simply inconsistent with observed arm’s length business arrangements. While a certain level of expertise is needed to evaluate whether or not a risky investment should be made, this is very different than exercising detailed control over how this investment is made and managed for the very simple reason that the expertise needed to manage the investment may lie with another company. Some common examples include:

- The fact that logistics is critical to the success of many different types of business operations does not prevent a number of very sophisticated and competent companies from outsourcing their logistics to specialized logistics companies such as Federal Express, UPS and DHL;
- A company that manages a rental property makes numerous decisions that impact the profits earned by the rent of that property (who will be allowed to rent; decisions around maintenance; collection of rent), but such decision making does not imply that it is entitled to share in the profits of the owner of the rental property (particularly it is paid a fixed
management fee) and certainly does not allow that management company to share in any increase in the market value of the rental property itself over time; and

- Many financial and insurance transactions involve the owner of capital deciding how much capital to invest, but using a broker or other third party to make detailed decisions around the investment of that capital.

Some of the industries where this issue is particularly important include: energy and natural resources, financial transactions generally, pharmaceuticals, asset leasing, and mining. This is an area where it would be useful for the Discussion Draft to emphasize the need to look at actual third party transactions for guidance.

Companies regularly minimize risks to the extent possible by hiring “experts” in contract manufacturing, R&D, logistics, procurement that have greater expertise than the contracting party. However, this greater expertise does not necessarily imply an ability to capture high rewards, as there are many sources of such expertise. In this regard, as a general matter, there is no reason to believe, for example, that a manufacturer that is part of a large MNE has greater expertise at managing/controlling/minimizing risk than available comparable manufacturers.

**Potential OECD Guidance Around Risk**

**Implications of De-Risking Certain Entities**

Transfer pricing structures with contractual limitations of risk can be of great practical benefit to tax authorities as well as taxpayers. A transfer pricing policy that targets distributor profit margins near some central tendency of comparables may not closely resemble arrangements between unrelated parties, and identification of the control functions aligned with the resulting risk allocation (as suggested in paragraph 76 of the discussion draft) is burdensome. Yet this policy protects the local tax authorities from losses and low profit results and further greatly simplifies the process of transfer pricing examination and dispute resolution.

KPMG believes that as a practical matter the comparables that are selected to provide net margin data for de-risked controlled transactions generally reflect the profit results that are consistent with a typical level of risk bearing, and may in fact not reflect the more limited risks of de-risked controlled entities. However, if the OECD is concerned that taxpayers may create risk adjustments that artificially depress profits, the OECD should address this problem directly rather than through a cumbersome and ultimately unworkable examination of decision-making. For example, the OECD may want examine whether certain limits can or should be imposed on the risk-return tradeoff, particularly given the BEPS concern that profits are being stripped from local de-risked operating companies. By analogy, while an investor with a portfolio of investments could choose to put all of those investments in very low risk instruments with a low but certain return, the question arises as to whether a prudent investor would/should do this over the long run given that it is generally
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possible to get a higher return with relatively little incremental risk through a more diversified portfolio. In the transfer pricing context, the question is whether at some point an operating company would refuse to enter into an arrangement that was very low profit/low risk when a slightly more risky arrangement would provide for higher long term profit expectations.

In this regard, it would be useful for the OECD to develop some examples illustrating situations that should or should not attract additional scrutiny on the part of the tax authority. For example, a vanilla LRD arrangement with a return targeted within the range of a standard comparable set should not invite a detailed scrutiny of the function / risk alignment – there is no reason to expect that the capabilities and resources of a distributor are affected by whether it is part of a corporate group. But it may be appropriate to place reasonable limits on circumstances in which profits can be “risk-adjusted” down based on the LRD characterization.

Substance and Risk

The OECD work on the BEPS initiative is clearly concerned with situation in which entities with little or no substance attract substantial profits. While KPMG believes that this concern is generally best met through targeted special measures rather than changes in the arm’s length standard, as in the case of LRDS the OECD may want to consider if it is appropriate to define minimal levels of substance and decision making capability in companies that manage valuable intangible and other assets, and which assume risk taking functions. However, these requirements should be ones that can be documented and maintained in a pragmatic manner that is consistent with the way in which MNEs manage their businesses, and should be targeted at avoiding abusive situations. For example, the OECD Guidance could set forth a level of decision making resources and capability that is needed in a principal company (e.g., that it have some senior employees that are capable of actively participating in the decision making of the relevant MNE business.) However, whatever standards are developed should take into account the practical realities of the way in which MNEs operate their businesses; e.g., through the use of a group of key decision-makers that may be located in different entities; the fact that the locus of key decisions may change abruptly if a key executive leaves the MNE and is replaced by a different executive with the same responsibilities that is located in a different country. (The fact that the head of R&D is in Country X in 2014 but moves to Country Y in 2015 should not lead to a change in rights to intangible profits). Given the inherent difficulty in developing generalized rules around the minimum level of substance that is needed, one option might be to identify certain factors that would lead to a shift in the burden of proof if there is too little substance.

Recharacterization

2 The concepts of realistic alternatives and risk analysis are fundamentally time-dependent, and therefore distinguishing between the ex ante assumption of risk and the ex post realization of risk is critical. However, while the Discussion Draft
“Recharacterization” occurs whenever clearly defined, up-front business arrangements established by MNEs are replaced by alternative arrangements that are developed several years later after the outcomes of events are known. The recharacterization of prior arrangements by taxpayers is inappropriate, and tax authorities have every right to assert outcomes that are consistent with the relationships that have been established up-front. But recharacterizations by tax authorities are equally problematic, in that they undermine the ability of the most responsible taxpayer to accurately assess its tax obligation, lead to larger and less resolvable disputes between tax authorities and taxpayers, and undermine the ability to resolve disputes during the course of Competent Authority (“CA”) negotiations. At a very colloquial level, it is very easy to argue that the purchase of a lottery ticket is “irrational” and should be disregarded when the expected payout is negative. However, revisiting this decision after the lottery ticket has proved either worthless or very valuable obviously provides each side with a strong incentive to argue for a results-based decision as to whether to respect the initial transaction. As a general matter, KPMG believes that disregarding contractual terms not only ignores arm’s length behavior (which is driven off of *ex ante* expectations) but is also bad tax policy, as it provides tax authorities with an obvious incentive and opportunity to make self-interested decisions.

**Treatment of Contractual Arrangements**

The Discussion Draft position that contractual arrangements are at best the starting point in determining the “accurately delineated transaction” invites tax authorities to disregard the business arrangements established by the taxpayer in favor of one that is different from the one that is contracted. This is simply re-characterization by another name, and will lead to all of the negative implications of such re-characterization. Determining what prices should be at arm’s length is difficult enough, even if all sides agree on the allocation of risks. However, it becomes much more difficult if there is a fundamental difference in views over which party bears risks, and therefore who is entitled to realize the fruits of unexpected success or bear the costs of unexpected disasters.

Given this, taxpayers must have the ability to define an *ex ante*, up-front business relationship and risk allocation among the various participants in their supply chains that will be respected even after the actual outcome of events and the *ex post* realization of risk is known. Tax authorities should require the use of arm’s length prices that are consistent with this business relationship, and require

occasionally mentions “expected” returns, in general it often appears to presume not only that a highly-technical analysis of alternatives is possible by the tax authority, but that its judgment about what was realistic 2, 3, or more years in the past is more reliable than management’s information and judgment at the time. Moreover, we know from practice that what actually has occurred with respect to the realization of risk quickly becomes what should have been expected. The standard that is being set forth in the guidance and examples is an open invitation to the application of hindsight.
that taxpayers adhere to the up-front relationships that they have established, but should be expected to do so within the confines of the business relationship/risk allocation established by the taxpayer absent substantial abuse.

**Options Realistically Available**

KPMG has two fundamental concerns with the Discussion Draft’s treatment of the concept of the options that are realistically available to the participants in a controlled transaction. The first is that failure to stress that the options of both sides to the transaction have to be taken into account. Take the case of an automotive supplier that is selling to a car manufacturer. The car manufacturer transfers its manufacturing facilities from Country A to Country B, and insists that the automotive supplier move its manufacturing operations to Country B as a condition of continuing its supplier relationship. The Country A CFC of the automotive suppliers does not have the “realistic alternative” of staying in business in Country A. Therefore, the Discussion Draft should emphasize that the evaluation of options realistically available to companies operating at arm’s length is a two-sided analysis. These issues are discussed clearly in Chapter IX.B.3 (notably 9.62).

The second equally important concern is that the impact of realistically available options should be taken into account by determining their impact upon controlled prices given the up-front business arrangement established by the taxpayer, and should not be used as an excuse for re-characterizing the transaction. As a simple illustration of this point, a legal entity that has the option to buy land that is particularly well suited for a wind farm for a below-market price can be expected to monetize this advantage, and to earn higher profits as a result – it would at arm’s length have the option of using that right in a similar transaction with a third party. A transfer pricing policy that did not reflect the value of this option would not give a correct result.

This is not the same, however, as saying that the option to obtain the land at a below market price would allow the legal entity to insist on a particular form of the transaction (e.g., a profit split rather than a cost plus in which the plus has been adjusted upward to reflect the value of realistically available options). Moreover, it is especially inappropriate for a tax authority to come in several years after the fact and say that the legal entity that it is examining could have entered into a profit split arrangement and that it therefore could have captured the benefits of a better than expected economic performance even though the contractual arrangement among the parties was one that limited its downside risk along with its upside potential. Adjustments to reflect options realistically available should be used to obtain the correct arm’s length price given the contractual and business arrangements that have been established by the MNE, and not be used as an excuse to replace these arrangements with a different set of arrangements. The latter is by definition recharacterization.
Moral Hazard

The Discussion Draft introduces the concept of “moral hazard” as a factor that may limit the separation of decision making over risk from the assumption of risk. In essence, the Discussion Draft argues that Entity A is unlikely to assume Risk X if Entity B can control the risk and use that control to affect the profits of Entity A. Using paragraph 62 as an example, it appears as though the OECD is concerned with the possibility that the risk of a sudden drop in demand could be assigned to Affiliated Distributor A in Country A even though all decisions as to how much to produce are made by affiliated Supplier B in Country B. Supplier B, for example, could decide to produce a sufficient volume to keep its plant operating at full capacity even in the face of evidence that market demand was not adequate. Supplier B could in effect protect its profits by putting Distributor A at a risk of loss if it is forced to buy more than it can sell.

There are several problems with Discussion Draft’s treatment of moral hazard. First, the decision to over-produce in the example above leaves the MNE as a whole worse off than it would have been, had it curtailed production to reflect reduced demand. The fact that it did not do so presumably reflects the fact that it is not omniscient, and did not foresee the downturn. An MNE can be expected to take whatever steps are appropriate to minimize volume or other foreseeable risks, and such steps are almost certain to involve providing the decision maker – regardless of where that decision maker is located – with the information that is needed to make an informed decision. Once this is done, the location of decision maker becomes irrelevant – access to the same information, coupled with the need to manage risk most effectively for the overall MNE – implies that the same decision will be made regardless of where the decision maker is located. As a very simple illustration of this point, the likelihood that the home team in a sports event will win or lose a coin toss does not change depending upon whether the home team or the visiting team gets to express a preference for heads or tails – as long as that preference has to be expressed before the coin is tossed. (Who does not matter; when does.)

There are, however, two key situations in which the assignment of risk to a specific entity becomes important, leading to moral hazard. The first is if risk is systematically mis-priced. Under such circumstances, the assignment of risk will lead to understated expected profits for one entity and overstated expected profits for the other. This is essentially ensuring that the coin in the coin toss is not biased, and that there is a 50:50 chance of heads or tails. But this is a standard transfer pricing problem, and there is a considerable amount of expertise and experience that can be drawn upon in the pricing of ex ante risk as long as the risk is clearly specified. But risk cannot be priced unless it is specified up-front.

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3 The economic concept of “moral hazard” may be useful at a high level for considering issues around control over risks. However the OECD should recognize that this concept is merely an entry point for an extensive and complex economic literature on managerial control. An approach to transfer pricing practice resting on that literature would require a major effort that would be very unlikely to result in practical guidance useful to resource-limited tax authorities (and taxpayers).
The second and much more pernicious situation leading to “moral hazard” around the assignment of risk is allowing the risk to be assigned ex post, after the outcome of risk is known. Consider the coin toss example above. While the question of who gets to call “heads or tails” is irrelevant as long as the call is made before the coin toss, if one team is given the ability to call “heads” or “tails” after the coin has been tossed and the outcome is known, there is a substantial “moral hazard” that whichever team is making the call will base the call on the known outcome. The same simple concept applies in the assignment of risk in transfer pricing. Moreover, it applies in MAP negotiations as well as in negotiations between taxpayers and tax authorities, and therefore undermines Action 14 objectives.

The OECD Guidance should therefore stress the need for a clear and up-front specification of risk in as much detail as possible. Tax authorities should have the right to enforce such an up-front assignment of risk, but should also be bound to respect the risk assignment.

**Behavior that is Inconsistent with Contractual Arrangements**

One issue that has to be addressed in the OECD guidance is how to deal with situations in which the taxpayer does not adhere to the contractual terms/business arrangements that have been established up-front. There are two basic approaches to addressing this issue:

1. Respecting the contractual agreement. Under this approach, controlled pricing is set based on the terms of the agreement. Moreover, the tax authorities should be able to enforce the terms of the contract, should this be necessary.
2. Using the actual behavior of the parties to make an after-the-fact determination of what the up-front agreement should have been.

If contractual terms are clearly determined up-front, and are ones that are consistent with the terms that would have been accepted in an arrangement between uncontrolled parties, the first approach should be used for the reasons that have been discussed above. Moreover, the OECD should provide guidance that clearly spells out the steps that will allow taxpayers to establish such an up-front contractual arrangement.

Not all contractual arrangements provide clear up-front guidance, however. Under some circumstances, they simply reflect a lack of clarity – the agreement either does not exist or is not spelled out in sufficient detail. While this obviously increases the difficulty in determining up-front arrangements, the preferred approach under such circumstances should be to determine the terms of the contemporaneous agreement based on the best evidence at the time. Transfer pricing documentation prepared by taxpayers is often helpful in this regard. Paragraph 4, for example,
discusses an example in which the up-front arrangement is for Company S to provide distribution, selling and marketing activities for Parent P, but where Company S lacks the capabilities to perform such activities. The Discussion Draft then takes this position, in effect, that tax authorities should carefully review where the actual activities are performed and re-define the terms of whatever up-front agreement exists to reflect the location of these activities.

At one level, the Discussion Draft is making an obvious point: a legal entity should not receive compensation for activities that it is not responsible for. In the example given above, a distributor that provides only warehousing and basic distribution/warehousing functions should not receive compensation for activities that it does not carry out (e.g., advertising, marketing). However, the Discussion Draft appears to assume that this is the common case, as opposed to the exception, and fails to provide clear parameters for distinguishing abusive transactions from the vast majority of transactions that are routine and unexceptional in nature. Because of this, the Discussion Draft appears to encourage detailed analyses which will create an enormous resource burden on both taxpayers and tax authorities, and will result in greatly expanded disputes and double taxation cases. Any final revisions to Chapter I should include substantial guidance, including examples, to assist both taxpayers and tax authorities in understanding circumstances where such analyses are likely to be important in avoiding material distortions in taxable income.

**Issues with Section D.1 examples**

Several of the examples presented by the Discussion Draft’s discussion of delineation of the transaction are particularly troubling.

The example in Section 4 describes an entity S that “acts as a distributor” for related company P, “primarily supplying independent distributors.” This language would generally be expected to mean that S purchases goods from P – a tangible goods transaction. The example then provides that “the contract … states that S will provide distribution services” which appears to mean S does not take title to the goods. However the example is silent on this seemingly important characterization issue. Instead it discusses issues regarding the extent of marketing services provided by S. The example as written raises the following observations: (a) if S is taking title to the goods, characterizing as a services transaction is clearly wrong, and the example should focus on the implications of that mischaracterization; (b) if S is in fact a buy-sell distributor, the fact that it engages in marketing and brand development activities would be fully consistent with the character of the transaction; (c) if S is not buy-sell, that should be made explicit and the nature of the contractual “distribution services” clarified (e.g. if they exclude marketing activities it would be clearer to specify that it provides warehousing and logistics services); (d) in either case it is not at all clear why the issues in this example are anything other than well-known, garden variety issues that could be addressed in terms of accurate functional analysis of S to properly inform selection of comparables, rather than
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essentially involving “accurate delineation of the transaction.” The examples should be clear why recharacterization of the transaction is essential to avoiding material distortion of taxable income.

The example in paragraph 6 explicitly concludes that a transaction delineated by the legal arrangements as P licensing intangibles and providing services to S, should instead be treated as S providing services to P. Such a conclusion plainly involves a recharacterization of the transaction. The OECD could substantially illuminate its thinking by explaining whether the facts as stated meet the standards for recharacterization in existing guidance, and if not why changing those standards is needed in order to prevent a material distortion of taxable income.

The insurance example in Paragraph 18 is unclear both with respect to the intercompany transaction under consideration and the problem addressed. The example appears to be related to the issue of “implicit guarantees” among group members and implications for pricing of financing transactions; if so this is a complex issue that should be addressed separately and is not appropriate for a section on functional analysis; regardless, the example needs to be substantially clarified or deleted.

Finally, Paragraph 21 notes that the various activities of an MNE may be highly fragmented, and that a considerable level of coordination may be needed among different legal entities carrying out specific functions. Paragraph 21 then concludes that under such circumstances, it will be important to determine the nature of the interdependence and how it is coordinated. While the factual part of the statement in Paragraph 21 is clearly true – MNEs often have a high level of specialization of functions – the objective of the discussion is less clear. Such specialization and coordination also occurs in third party arrangements – as is evidenced by extensive use of third party logistics companies.

**Fragmentation**

Continuing with the theme that MNEs are often highly integrated, the Discussion Draft implies that reliable comparables generally cannot be identified for the group functions of such an MNE—establishing the premise for application of a transactional profits split method. This implication is unfounded and the Discussion Draft should be amended to clarify that outsourcing integrated functions and risks to associated enterprises (referred to as “fragmentation” in the Discussion Draft) is a comparability factor that should be considered in selecting the most reliable transfer pricing method.

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4 “Where fragmentation gives rise to significant comparability challenges, it may be feasible to support the outcomes of pricing based on potential comparables with a transactional profit split approach.” OECD Discussion Draft on Profit Splits (Dec 16, 2014, Section 4, para 27).
The Discussion Draft states that a functional analysis is a necessary step to delineating transactions between controlled parties and determining comparability. (Section D.1, para 16). An example is provided of an associated logistics company that is required to operate with spare capacity to ensure timely supply. Observing that uncontrolled logistics companies would minimize excess warehousing capacity, the example concludes, “. . . [the associated enterprise’s] functions may, therefore, be different to those of an independent logistics company which did not offer the same capabilities to reduce the risk of disruption to supply.” (Section D.1, para 17). It is not clear why the functions of the associated logistics company and the independent logistic company would be ‘different.’ Rather, it seems more logical to conclude that the functions are ‘similar’ but that comparability adjustments should be evaluated to account for differences in assets (e.g., redundant warehouse space) employed.

Fragmentation requires coordination. The Discussion Draft observes that, “the required coordination may be performed by some or all of the companies performing the fragmented activities, through a separate coordination function, or through a combination of both. Risk may be managed through contributions from all the parties, or performed mainly by the coordination function.” (Section D.1, para 21). The coordination function is often a high-value function and should be considered in the comparability analysis with no bias toward the use of transactional profit split methods. The Discussion Draft correctly observes 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 . . . . While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions . . . that is important.” Put differently, it is the coordination and oversight of outsourced functions that is economically significant and illustrative of the manner in which business is often carried out through outsourcing (both to associated and independent contractors). The Discussion Draft should clarify that fragmentation, or outsourcing, is a common feature of the value chains of most MNEs (including significant outsourcing to independent contractors) and is merely another factor to consider in analyzing comparability.

Special Measures

Conceptual Discussion

There is nothing in the arm’s length standard per se that prevents the double non-taxation of income that is a key objective of the current BEPS project. Capital is mobile, and at arm’s length capital attracts an arm’s length return. Capital, and its associated return, can be invested in a jurisdiction or under preferential tax regimes that may produce outcomes that are inconsistent with tax policy.

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5 Indeed, this type of coordination is frequently observed between independent parties. For example, one of the leading content streaming companies outsources critical value-chain functions (content development, reliable content streaming, etc.). The content company provides coordination, oversight and control of its outsourced contractors.
Headquarters Company A in Country A may invest in CFC B in Country B, and have CFC B acquire intangibles, financial instruments, mineral rights, etc. that allow CFC B to earn profits of X. These profits may arise from collecting an arm’s length charge from CFC C in Country C. As a general matter, the amount of that arm’s length charge will not depend upon whether Country B imposes a tax of 20%, 50% or 0% on the profits of CFC B, or even whether Country B has a general tax rate of 20% but imposes a 0% tax on CFC B for whatever reason. However, the 0% tax – especially if it is a “special” 0% rate when the general rate in Country B is 20% – almost certainly leads to double non-taxation as defined by the OECD in its BEPS initiative.

Assuming no change to the Country B tax regime, the problem can be addressed by having tax rules that allow the tax authority of another related entity (in this case either Headquarters Company A or CFC C) impose a tax on the X of profits earned by CFC B. Such “special measures” can take various forms. The Discussion Draft addresses transfer pricing based special measures. Other Action Items in the BEPS project are examining special measures in the form of controlled foreign corporation rules or changes to international standards for jurisdiction to tax, including through the definition of a permanent establishment and examination of sourcing rules. However, it is important to realize that if such “special measures” arise through transfer pricing, these will allow the tax authorities of either Country A or Country C to collect taxes on an amount of income that is greater than that which they would be able to tax at arm’s length. (The arm’s length profit of X related to CFC B’s ownership and/or functions is properly income that is subject to tax in Country B; it is only because of the failure of Country B to impose an appropriate tax that special measures are needed.) While this may be completely consistent with the OECD’s objectives in the BEPS project, it raises complex tax issues that have essentially nothing to do with the issue of determining what transfer prices should be at arm’s length. Such issues include:

- Determining what aspects of Country B’s tax system trigger the right of another country to collect taxes on the profits of CFC B
- Assuming a trigger, determining whether Country A or Country C should have the primary right to collect tax on the profits of CFC B;
- What is the minimal “nexus” that has to exist between the activities of Country A or Country C with those of CFC B to create the right to tax CFC B’s income under a special measure?; and
- What happens if the tax policy of Country B changes, and it decides to impose a tax, or if the multinational in question changes its structure such that the circumstances that triggered the special measure no longer apply, which presumably will result in a loss of tax revenues by the country benefitting from the special measures?

The key point is that these issues have nothing to do with transfer pricing, and the careless mixing of special measure and transfer pricing will lead both to a lack of clarity on the role of the special measures and to increased uncertainty over which country has the right to tax. Take the last issue
set forth above as an example: If the tax authorities of Country C believe that they have an arm’s length claim to tax the income of CFC B, they are unlikely to accept the fact that Country B has the right to tax this income if it changes its tax rules.

It is also important to recognize that there is an important difference between (i) taxing the income of CFC B under a non-transfer pricing special measure while respecting the fact that CFC B is entitled to the profits that it would earn at arm’s length and (ii) using a transfer pricing special measure that reallocates the income of CFC B to a different legal entity. The former simply imposes a tax on the income of CFC B; the latter changes the location of the profits, and therefore implicates issues around dividend repatriation, the tracking of earnings and profits, and the ability of CFCs to meet potential real business obligations (e.g., for an insurance company to meet claims of policy holders, the ability of the owner of a drug to pay out a large fine triggered by unexpected patient deaths). Simply imposing a tax on the income of CFC B has fewer collateral issues than reallocating its income, and is therefore to be preferred.

There is nothing especially novel about the use of specific rules to reach a specific desired tax result or to prevent results that are inconsistent with tax policy. Most anti-abuse rules could be characterized as a “special measure” of some sort; rules on the taxation of passive income are designed to prevent a type of highly mobile income from escaping the tax net. That said, when such special measures are used, good tax policy suggests that they:

- Be clearly and narrowly targeted at the specific abuse they are designed to correct;
- Have a clear and administrable definition of when they apply.

On balance, we believe that special measures imposed through transfer pricing will fail to provide the specificity and clarity necessary for successful tax administration. Such special measures should therefore be pursued outside the transfer pricing space.

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**About KPMG**

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 162,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.
Date: January 16, 2015

To: Mr. Andrew Hickman, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration

From: David R. Jarczyk, ktMINE, CEO

Subject: Comment on Public Discussion Draft BEPS ACTIONS 8, 9 AND 10

Dear Mr. Hickman:

In its capacity as an intellectual property data company, and as a small business with significant interests in transfer pricing matters, ktMINE humbly submits the following comments related to the revised Discussion Draft. Any questions or comments should be forward to David R. Jarczyk at david.jarczyk@ktMINE.com or (773) 401-8962.

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I sincerely applaud the quality and content of the Discussion Draft. Specifically, I agree that transfer pricing analyses of intercompany transactions should be 1) the determination of the conditions that would be agreed upon between independent parties, as well as 2) dependent on evidence of market behaviors.

The Discussion Draft has a recurring theme, best communicated in the introduction as “rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.” The objective is to assure that transfer pricing outcomes are in line with value creation. One prudent way to accomplish this is by understanding the form, substance, and valuation of transactions (a.k.a. functions, risks, and pricing) that occur between unrelated parties. In fact, the real theme of the revised discussion draft can be summarized by one question: how would independent parties behave given the tested transactions’ facts and circumstances?

Market evidence (or “comparables”) can and should be used 1) to determine the behaviors - specifically the deal structure including functions performed, risks assumed, and assets utilized - of independent parties to transactions, and 2) to determine the arm’s length pricing in such transactions. By failing to examine the behaviors of the market, tax payers and practitioners are not exercising proper due diligence to complete a prudent arm’s length analysis.

The revised discussion draft spends significant time asking “how would independent parties act given the tested transactions’ facts and circumstances”, yet lacks guidance on what market evidence exists to determine an answer. It is my hope this document begins the discussion on this matter.
I humbly suggest including language in the guidance that provides an introduction to the data that is available. It is my opinion that it is ineffective to ask practitioners to answer a question (e.g., how would independent parties behave?) and not provide them with the tools to answer the question (e.g., sources of market evidence). I submit the language provided in the next section for addition to the draft.

Sincerely,

David R. Jarczyk
ktMINE, CEO
PROPOSED LANGUAGE FOR INCLUSION

Determination of Arm’s Length Conditions
Agreements are available in the public domain that encompass the deal terms and conditions between independent parties. This data can and should be utilized to identify evidence of deal structures typical among independent parties. The use of this information provides transparency to the behavior of independent parties; specifically, the functions performed, risks assumed, intangibles utilized, and payment terms agreed upon.

Agreements exists for a multitude of transaction types, including:

- Toll/Contract Manufacturing;
- Financial Services;
- Sales and Buying Agents;
- R&D and Engineering Services;
- Management Services; and
- License of Intangibles.

This set of data can be used as benchmarks to structure related party transactions. With this market evidence practitioners can better answer any structural questions, including those listed below.

- Do independent parties share significant fluctuations in foreign exchange rates?
- Would a licensee pay to register a licensor’s intangibles in the licensed territory?
- How do third parties share rebates?
- Would a contract manufacturer bear warranty risk or product liability risk?
- Would independent parties set a price to increase as sales of a product increase?
Determination of Arm’s Length Pricing
Agreements within the public domain include information on payment structures as well as the payments themselves for a multitude of transaction types, including those mentioned in the previous section. The use of this information provides market evidence of pricing structures and prices typical among independent parties. Used in conjunction with a prudent analysis that considers factors of comparability, these data points provide benchmarks for related party transactions.

Payment terms exist for a variety of structures, including:

- Gross Sales;
- Net Sales;
- Cost Plus;
- Gross Profit;
- Operating Profit;
- Assets; and
- Per unit.

Various valuable insights into how independent parties construct payment terms extend beyond the royalty rates being paid. These include answers to the following questions:

- What are the events that trigger payments?
- When are licensees incurring interest charges?
- What is the royalty base definition?
- Are there milestone payments?
- What are the audit terms around the royalty payment?
- Would third parties agree to royalty reductions due to profitability?
- Would third parties agree to royalty offsets?
- What is the invoicing process?
Mr. A. Hickman  
Head of Transfer Pricing Unit  
OECD Centre for Tax Policy and Administration

Dear Mr Hickman,

In response to the invitation of the OECD to interested parties to provide comments on the public discussion draft on “Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)” (the “Discussion Draft”), please find in this letter the comments on the Discussion Draft on behalf of Loyens & Loeff N.V.¹ (“Loyens & Loeff”, “we” or derivative terms).

Loyens & Loeff appreciate the work done by Working Party No. 6 on the Taxation of Multinational Enterprises, in developing revisions to Chapter I of the OECD Transfer Pricing Guidelines. We have examined with great interest the proposed revisions of Chapter I, and we welcome the opportunity to submit comments on the Discussion Draft.

The comments we provide in this letter are our own comments as tax professionals. They do not represent the comments of particular clients.

Our comments to the Discussion Draft are divided in three categories, i.e. (i) fundamental comments to the arm’s length principle, (ii) comments to the interpretation of the arm’s length principle in the Discussion Draft, and (iii) our input on a selection of the questions raised in the Discussion Draft.

In summary, we invite the OECD to clarify that it is worthwhile creating new complexity, uncertainty and inefficiency. We recommend adding a paragraph that clearly describes the goals of the Discussion Draft, and explains that the draft reaches these goals in the “best alternative realistically available”.

¹ As a leading firm, Loyens & Loeff is the natural choice for a legal and tax partner if you do business in or from the Netherlands, Belgium and Luxembourg, our home markets. You can count on personal advice from any of our 900 advisers based in one of our offices in the Benelux or in key financial centres around the world. Thanks to our full-service practice, specific sector experience and thorough understanding of the market, our advisers comprehend exactly what you need.

The public limited liability company Loyens & Loeff N.V. is established in Rotterdam and is registered with the Trade Register of the Chamber of Commerce and Industry under number 24370586. Solely Loyens & Loeff N.V. shall operate as contracting agent. All its services shall be governed by its General Terms and Conditions, including, inter alia, a limitation of liability and a nomination of competent jurisdiction. These General Terms and Conditions may be consulted via www.loyensloeff.com. The conditions were deposited with the Registry of the Rotterdam District Court on 1 July 2009 under number 43/2009.
1 Resolving the core problem

A system of international taxation should be fair, effective and efficient. A tax system is considered

- **fair** if it is supported by the social perceptions of fairness;
- **effective** if the goals of the tax system are realized, meaning that the system (a) should raise taxes for governments and (b) should minimize the possibilities for tax payers to avoid taxation by exploiting differences between countries; and
- **efficient** if the goals of the tax system are realized at the lowest possible cost.

Witness the BEPS Project and its backgrounds, the current tax system of international taxation, in which the arm’s length principle is a fundamental building block, apparently no longer fulfils its task adequately. Loyens & Loeff believe that this observation should give rise to a more fundamental reconsideration of the sustainability of the tax system as a whole. In a recent study on the existing model of international corporate taxation, M.F. de Wilde states:

“*The current model of corporate taxation finds its origins in the 1920s. It well suited the economic realities of the early days of international trade and commerce; the times when international business primarily revolved around bulk trade and bricks-and-mortar industries. But those days are long gone. Globalization, European integration, the rise of multinational enterprises, e-commerce, and intangible assets have changed the world considerably.*

*These developments have caused the model to operate inconsistently with the economic reality of today. Corporate taxation and economic reality are no longer aligned. The model is ill-suited to current market realities. As a result multinational business decisions are distorted by tax considerations. The arbitrage may work to the benefit or detriment of nationally and internationally active firms. It also seems to put pressure on nation state corporate tax revenue levels. This may lead to spill-over effects and welfare losses at the end of the day. Matters seem to worsen in today’s increasingly globalizing economy.*”

M.F. de Wilde also suggests a solution. The Discussion Draft does not address the fundamental problems underlying the system, but instead tries to “fix” alleged abuses that are caused by the system, by proposing ambiguous and inconsistent (see paragraph 2) solutions that still don’t fit within the reality of the current international business practice. This approach will create new distortions:

- Some tax authorities will be tempted to argue that more profits should be allocated to them, provoked by the ambiguous and inconsistent guidance on how associated enterprises should behave in order comply with the arm’s length principle. Not being able to enforce or rely on unambiguous and consistent guidance, many uncertainties will arise for MNEs, invoking more disputes with tax authorities, undermining the tax system’s effectiveness and efficiency.

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2 Dr. M.F. de Wilde, *Sharing the Pie*: Taxing multinationals in a global market, Diss., Erasmus University Rotterdam, 2015, to be published and attached to these comments.
Other tax authorities will be tempted to attract new investments by offering tax breaks, ironically also enabled by the ambiguous and inconsistent guidance which leave them room to opportunistic but defendable interpretations of the guidelines, also undermining the tax system’s effectiveness and efficiency.

MNEs would be tempted to (artificially) centralize functions (potentially to tax friendly locations) to reduce the uncertainty resulting from the ambiguous and inconsistent guidance. This would hamper business, might trigger relocation of jobs and would lead to reduced tax revenue for tax authorities. Such incentive would potentially be counterproductive to achieving the objectives of the BEPS project.

Tax courts in various jurisdictions will perceive the ambiguous and inconsistent guidance that do not conform to economic reality as a less reliable source of information for resolving tax disputes. This will lead to differences in interpretation and application of the arm’s length principle between jurisdictions, leading to more instead of less opportunities to exploit differences between countries. It would also diminish the value the OECD guidelines traditionally have had in the practical application of the arm’s length principle.

The Discussion Draft appears to have the goal to treat all entities of a group as permanent establishment of one entity (i.e. ignore legal ownership and contractual agreements of separate entities). Such an approach would require a more drastic change than simply “stretching” the arm’s length principle beyond its original purpose.

Without a reconsideration of the fundamental choices underlying a fair allocation of the rights of countries to tax the profits of an MNE, we fear that the attempt to fix the issues of the current tax system by combatting the symptoms, rather than the disease caused by the system, will not result in a more fair, effective and efficient system of international taxation.

We invite the OECD to clarify that it is worthwhile creating new complexity, uncertainty and inefficiency. We recommend adding a paragraph that clearly describes the goals of the Discussion Draft, and explains that the draft reaches these goals in the “best alternative realistically available”.

2 Comments to the interpretation of the arm’s length principle in the Discussion Draft

Loyens & Loeff believe that the proposed interpretations of the arm’s length principle in the Discussion Draft do not conform to economic reality and are inconsistent and ambiguous.

(i) With normative notions from economic theory, the Discussion Draft diverges from economic reality

The Discussion Draft selectively uses economic theory to substantiate how affiliated entities should conclude transactions. We believe that the Discussion Draft needs to be more thoroughly founded on economic reality, not on normative notions of how independent
enterprises in an ideal world should conclude transactions. The Discussion Draft appears to diverge from the reality of transactions between independent enterprises:

- The Discussion Draft is *inter alia* based on the assumption that independent enterprises behave in a commercially rational manner. Modern behavioural economic science has shown that in reality the assumption of rational economic decision-making is false. The Discussion Draft suggests that unrelated parties only enter into transactions if there are no better alternatives. Economic decision-making, however, is marked by limited rationality and opportunism. Economic decisions are made mainly on the basis of heuristics (rules of thumb), not on well-considered choices between all the options available. Herbert Simon has proved that agents in an organizations are keener to choose the option that is ‘good enough’ rather than the best among all options available. It would therefore not be appropriate to assume a level of rationality for associated enterprises that does not apply to independent enterprises in the context of a rule that imposes that related parties should act as independent parties. The arm’s length principle’s purpose is to allocate the right to tax the profits that an MNE actually makes and not to enable tax authorities to tax profits that an associated enterprise could have made if it behaved according to normative (imposed) economic theory.

- The Discussion Draft puts more emphasis on functions than on assets and risks. For example, the Discussion Draft changed the wording regarding risks from *risks assumed* to *risks assumed and managed*. The Discussion Draft appears to assume that value creation is caused primarily by people functions, rather than by assets used and capital employed. This assumption, however, contradicts fundamentally with economic reality: market prices reflect scarcity rather than pure human activity. While the basis of economics is the allocation of scarce resources, no reference is made in the Discussion Draft to the impact of the scarcity of functions (well trained employees) and assets (capital) on the price that can be demanded for making available employees or capital.

- The Discussion Draft concludes that it should not follow from the freedom of MNEs to control the structure of their transactions where profits arise for transfer pricing purposes, but that, instead, it should be determined whether the resulting transactions have arm’s length attributes. Loyens & Loeff note that an MNE group member’s *raison d’être* is to contribute to the overall group strategy. The arm’s length principle fictionally assumes that each member has its own objective of making profits. If an MNE were to structure its organisation and its commercial behaviour in accordance with this fiction, it would unnecessarily restrict its freedom to organise itself efficiently, which economic
reality requires. The arm’s length principle is not meant to require from an MNE to conform its organisation and commercial behaviour to the fiction of independence, but rather to allocate the right to tax profits that result from an effective and efficient organisation and commercial transactions.

(ii) The Discussion Draft's inconsistency provokes tax authorities to opportunistically apply economic concepts for their benefit

The Discussion Draft appears to be inconsistent in using economic concepts to substantiate how independent parties conclude transactions. This bears the risk of provoking tax authorities to use economic concepts opportunistically, while denying these economic concepts in other (discomforting) circumstances:

- On the one hand, the Discussion Draft prescribes unrestrained commercially rational behaviour in transactions between related parties by assuming that both parties to a transaction must have a reasonable expectation to enhance their financial position. On the other hand, however, the Discussion Draft states that for a transaction to be recognized, the MNE Group may not be left worse off on a pre-tax basis, whilst a rationally behaving market party will only base its decision making on a post-tax basis rather than on a pre-tax basis.\(^6\)

- On the one hand, the Discussion Draft prescribes unrestrained commercially rational behaviour in transactions between related parties by assuming that both parties to a transaction must have a reasonable expectation to enhance their financial position.\(^7\) On the other hand, however, the Discussion Draft states that parties should not base their transactions on a risk-return trade-off, whilst such trade-off is the main reason for many rational behaving independent market parties to enter into a transaction.\(^8\)

- On the one hand, the Discussion Draft states that MNE groups have the freedom to control their structures, including shareholding, capitalisation and legal form, which allows them to control the environment in which transactions occur.\(^9\) On the other hand the Discussion Draft suggests that related parties should put in place the same safeguards and incentives that unrelated parties would adopt to avoid “moral hazard”. It appears that the Discussion Draft here confuses the fiction that underlies the arm’s length principle, i.e. that the pricing of transactions by related enterprises should be comparable to those between unrelated parties, with the economic reality of an MNE in which related enterprises endeavour to contribute to the realization of common strategic

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\(^6\) Paragraph 89.
\(^7\) Paragraph 89.
\(^8\) Paragraph 71.
\(^9\) Paragraph 86.
objectives. These common strategic goals align the incentives of related parties and will contribute to avoid moral hazard rather than that these goals will provoke moral hazard.

- As discussed above, the arm’s length principle is based on the fiction of independence, whilst MNEs in reality have the freedom to organize the structure of their transactions. The fiction works both for and against the MNE. Using an MNE’s freedom to organise itself as an argument for disregarding a (commercially beneficial) transaction, while maintaining the independency fiction in situations where it works against the MNE, appears to be inconsistent.

(iii) Generalisations, vague concepts and suggestive examples make the Discussion Draft ambiguous

- The Discussion Draft uses general observations (e.g. ‘generally’, or ‘usually’) and subsequently suggests to apply these observations under all circumstances.

For example, para. 12 of the Discussion Draft states that “Independent enterprises will generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk or other comparability factors discussed below) when valuing those options.”

While this might be true in most cases, it is the situations in which this assumption does not hold that will trigger discussions in practice. Nonetheless, the Discussion Draft uses this general notion to draw conclusions which apply under all circumstances:

“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”.

- The Discussion Draft uses vague concepts to explain the arm’s length principle. A disturbing but important example is the proposed primacy of the ‘actual conduct’ of the parties in a transaction over the contractual relationship. In practice, the actual conduct of people deviates substantially from what they should be doing based on, for example, job descriptions and management reporting lines. In practice, whom of the employees in an MNE makes the actual decisions is driven by various circumstances, such as personal impact or the informal power of a staff member, which person of the staff has invented an idea, who has the capacity, capability, energy and spirit to put that idea into practice. The result thereof is that taking the ‘actual conduct’ of parties as starting point (i) makes it practically impossible to draw conclusions on who is doing what as this differs from time to time, and (ii) potentially leads to random outcomes and thus windfall profit allocations. In many situations it will be impossible to “trace” all steps in the invention of a successful idea, let alone how the decisions about implementing an idea
are actually made. To avoid the impracticalities of looking at actual conduct of people, people invented the use of contracts as a means of establishing relations between parties. Deviating from such contractual relations and requiring that profit be allocated based on actual conduct is in our view not a desirable development and contradicts with the consequences that contractual relations, job descriptions and management reporting lines have for staff members in terms of responsibilities and accountability. In so far as the Discussion Draft suggests that the proposed primacy of actual conduct is needed to fight fraudulent behaviour by MNEs, it is redundant, because the current guidelines and domestic legislations of various countries already provide sufficient instruments to encounter fraud.

- The examples in the Discussion Draft do not reflect situations which will cause discussions in practice. Instead, the Discussion Draft gives examples in which the interpretation of the arm’s length principle does not give rise to discussions. The Discussion Draft subsequently suggests that these examples demonstrate that the arm’s length principle can be explained in a similar way in other –less clear- situations.

The use of generalisations, vague concepts and suggestive examples makes the Discussion Draft ambiguous and undermines its stature.
3 Answers to a selection of the questions raised in the Discussion Draft

On page 14 and 15 of the Discussion Draft various questions are posed relating to moral hazard, risk-return trade-off and financial services sector. Hereinafter we provide our answers to the questions posed.

Loyens & Loeff have the following general remarks to the questions:

- Loyens & Loeff note that the questions do not address the fundamental problems underlying the current tax system. The questions instead ask for input on the suggested “solutions”, which are merely combatting the symptoms, rather than the disease caused by the system. Such an approach will create new distortions and “abuses” of the tax system. Loyens & Loeff believe that this observation should give rise to a more fundamental reconsideration of the sustainability of the tax system as a whole.

It appears that the Discussion Draft confuses the fiction that underlies the arm’s length principle, i.e. that the pricing of transactions by related enterprises should be comparable to those between unrelated parties, with the economic reality of an MNE in which related enterprises endeavour to contribute to the realization of common strategic objectives. The Discussion Draft thereby appears to have lost sight on the objective of the arm’s length principle, i.e. the allocation of the right to tax profits that an MNE actually makes. That objective is neither to force an MNE into behaviour that is inefficient or ineffective for its strategic objectives, nor to enable tax authorities to tax profits that an MNE’s group member could have made if it conformed itself to economic rational behaviour that economic theory assumes it have.

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 economic reality of an MNE is that related enterprises endeavour to contribute to the realization of common strategic objectives. These common strategic goals align the incentives of related parties and will contribute to avoid moral hazard rather than that these goals will provoke moral hazard. Imputed moral hazard should therefore not play a role in transactions among group companies.

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?

Contrary to third parties transacting with each other, group companies generally do share insights about the core competencies in order to enhance the value of their intellectual property and
increase market opportunities for the MNE. This is in the benefit of the MNE as a whole. Consequently, looking at the example given in paragraph 67, within an MNE insurances for core competencies would be given, since the insured company still will have the incentive to manage risks (to the extent it has the ability to do so) since that is in the interest of the MNE.

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 group companies in principle have the same commercial and strategic goals, i.e. increasing the value of the MNE, moral hazard should not play a role here. Also when ownership of the trademark is separated from the functions to maintain and enhance the value of the trademark, while this being monitored by the trademark owning company, the group companies together will have an incentive to do this in the best possible way. For they would like to add as much value as they can to the trademark since that is in the interest of the MNE as a whole.

Above answers show that transactions taking place within an MNE are not identical to transactions among third parties, since within an MNE the objective is to meet common strategic goals (as opposed to individual company goals in third party transactions.) Consequently, transactions may take place among group companies, that do not take place among third parties.

In addition, the example does not fit within the arm’s length principle:

- The example seems to assume that the transferee should have its own qualified staff that has the required expertise to exploit the trademark. In practice, however, transfers of intangible assets between third parties take place in which the parties do not have the relevant expertise themselves, but source this expertise from outside. It must also be noted that the labour market is changing rapidly and that it is becoming more common for companies to hire freelances instead of employing their “own” employees.\(^\text{10}\) This should not make any difference in determining whether the “capability to exploit the trademark” is present.

- In the example, the Discussion Draft puts most emphasis on functions, and not on risks and assets. The statements in the Discussion Draft are based on economic theories. Economics is the study of how people choose to allocate their scarce resources. It is therefore remarkable that the Discussion Draft does not take into account the scarcity of the various factors contributing to profit when stating that most emphasis is to be put on functions.

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\(^{10}\) According to research from the Dutch Central Statistical Office (Centraal Bureau voor de Statistiek), the number of freelances (without personnel) in the Netherlands increased from 330,000 in 1996 to over 800,000 in 2014. See http://www.cbs.nl/nl-NL/menu/themas/arbeid-sociale-zekerheid/publicaties/artikelen/archief/2014/2014-4230-ta.htm.
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?

Also within MNEs, transactions should be recognised if the sole effect is to shift risk. The reason to do so is that a central entity within the MNE pooling the management of certain risks should be better equipped to manage these risks or centrally outsource these risks. Examples include foreign exchange hedges, interest rate swaps and debt factoring, examples which are also provided in paragraph 67 of the Discussion Draft. Such transactions should be treated in the same way as comparable transactions taking place in the market place.

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?

Due the transfer of the trademark from S1 to S2, S1’s market risk is reduced. S1 will still incur some market risk, since S1 remains selling products in the market, but the market risk is reduced since the part of the market risk that relates to the intellectual property is borne by S2. If the intellectual property will be worth less this will have an effect on S2’s equity position and not on S1’s equity position. S1’s equity position will only be indirectly affected, if the market risk it incurs results in a loss for S1, i.e. if the market risk materialises to such an extent that besides reducing the value of the intellectual property, S1 also comes in a loss position due to reduced sales.

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?

The intellectual property risk should be considered to be incurred by S2. The fact that S1 forgoes profit potential relating to the ownership of the trademark in exchange for more constant income due to the reduced risk profile, should be respected. Also within the market, not all parties have the same risk appetite. The *ex ante* expected return should be in line with the risks that parties are exposed to.

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?

Yes, the risk-return trade-off in general applies to inter-company transactions involving the shifting of risk. However, when determining the net present value of an alternative, the discount rate applied should be substantiated from an arm’s length perspective and may not be manipulated to prove that the transaction is economically rational. Potential manipulations can be unveiled using generally accepted financial modelling techniques that independent parties also use to evaluate risk and return trade-offs for their decision-making, such as expected value calculations, real option
valuations, probabilistic (instead of deterministic) modelling and simulation of multiple economic scenarios.

Loyens & Loeff believes that no special measures are required to ensure appropriate policy outcomes, as long as the various elements of the transaction are substantiated based on the arm’s length principle, e.g. expected returns, discount rate, people involved in monitoring the risks, etc.

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?

No specific comments.

4 Comments to the Special Measures proposed by the Discussion Draft

In this paragraph we give our views on the various options proposed as special measures in the Discussion Draft.

Option 1: Hard-to-value intangibles

The special measure relating to hard-to-value intangibles would permit tax administrations to presume that a price adjustment would have to be adopted resulting in a recalculation based on actual outcome. The presumption may be rebuttable under certain conditions which may include situations where (i) the taxpayer can demonstrate the robustness of its *ex ante* projections, or (ii) the outcome does not differ more than [xx]% from the projections used *ex ante* to calculate the fixed price.

Loyens & Loeff believe that only under very special circumstances should a price adjustment be assumed for intangibles that are transferred. Applying price adjustments based on *ex post* outcomes undermines the fact that the risks relating to the intangibles have been transferred to the new owner of the intangibles and thus impacts the seller. Loyens & Loeff further note that modern decision-making practice provides advanced techniques to support decision-making under uncertainty, such as decision-tree analysis and real option valuation. These techniques are widely used in for example the pharmaceutical industry, oil & gas industry and high-tech industry. Taxpayers using these techniques to make their investment decisions under uncertainty should be allowed to similarly use these techniques for tax purposes. Loyens & Loeff welcome that no price adjustment takes place if the taxpayer has robust transfer pricing documentation in place substantiating the *ex ante* projections. The alternative of working with a certain deviating margin should be considered with prudence allowing for a vast deviating margin considered over a considerable time frame.
Option 2: Independent investor

The option to target inappropriate returns for providing capital from the perspective of an independent investor does not take into account the economic reality that capital is scarce. For example, in capital intensive industries, such as steel, mining, oil & gas, value can only be created if the required funding is available, which funding may be scarce due to the high risks to which the investments are exposed. Furthermore, in the private equity industry, the providers of capital funding are allocated often up to 80% of the profits and gains realised with the investment, while management receives a carried interest of 20% or less of the profit, although it provides the significant peoples functions to manage the value creation process. As scarcity is one of the main drivers of value creation in economic activity and capital funding is scarce, the independent investor approach would be a fundamental divergence from the arm’s length principle. Loyens & Loeff are of the opinion that such divergence should be acceptable only in the context of a fundamental reconsideration of the system of international taxation, and should not be implemented opportunistically. Loyens & Loeff therefore does not agree with allocating no or little return to capital rich, asset-owning companies.

Option 3: Thick capitalisation

The thick capitalisation proposal has no economic reality and would deny the value creation potential of providing scarce equity funding. It would deny the existence in the market of equity financed companies which provide funding for economic activity in transactions with third parties. The approach would be a fundamental divergence from the arm’s length principle. Loyens & Loeff are of the opinion that such divergence should be acceptable only in the context of a fundamental reconsideration of the system of international taxation, and should not be implemented opportunistically. Moreover, it proposes comparable concepts as applied to tackle excessive interest deductions which are dealt with under BEPS Action Plan 4, which would result in overkill.

Option 4: Minimal functional entity

The minimal functional entity (MFE) proposal has no economic reality. If the proposal is meant to combat tax avoidance in situations where the MFE has minimal people functions, but has other functions, such as providing capital and holding assets, the approach would be similar to the “independent investor approach” and the “thick capitalisation approach”. As discussed in the comments to these approaches, it would deny the value creation potential of providing scarce equity funding and thus deny the existence in the market of equity financed companies which provide funding for economic activity in transactions with third parties. The approach would be a fundamental divergence from the arm’s length principle. Loyens & Loeff are of the opinion that such divergence should be acceptable only in the context of a fundamental reconsideration of the system of international taxation, and should not be implemented opportunistically. If the MFE approach means to deny profit allocation to an entity that lacks any functionality, it appears redundant, as the existing interpretation of the arm’s length principle should result in an outcome that is in line with
what independent enterprises would realize (and pay tax on), i.e. a small remuneration. This would make the minimal functional entity concept needless.

Option 5: Ensuring appropriate taxation of excess returns

Loyens & Loeff deems it more appropriate to comment on CFC elements in the consultation process of BEPS Action 3 “Strengthen CFC rules”.

Respectfully submitted,

Yours sincerely,
Loyens & Loeff N.V.

[...]
6 February 2015

Dear Mr Hickman,

We write in response to the request for comments on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures).

Overall, we believe that the Discussion Draft does help in assuring that transfer pricing outcomes are in line with value creation. We agree with the Discussion Draft on the importance of delineating the actual transactions accurately and the detailed guidance on the analysis of risk for a functional analysis. Furthermore, we agree that conduct of parties should take precedence over contractual arrangements when there are differences between the two.

We do not agree that where there is a lack of comparable uncontrolled transactions this means that the arm’s length principle cannot be applied. We suggest that transfer pricing transactions that do not take place between independent parties should be done using the principles of finance and micro-economics to attribute value.

In our opinion, some of the special measures outlined in Part II of the Discussion Draft could help in tackling base erosion and profit shifting (BEPS). However, the measures discussed would increase the compliance burden for taxpayers across the board. While this may be acceptable for high value transactions, it underlines the need for further exemptions for smaller taxpayers and lower value transactions. Measures beyond the SME exemptions already offered by some jurisdictions, further work on safe harbours and the low value added services proposal may assist in this respect.

The comments provided below are in relation to the questions the Discussion Draft poses to the reader. We have split these comments between the questions in Part I and those in Part II of the document.

**Comments in relation to Part I of the Discussion Draft (pages 14 – 15):**

1. Where the arm’s length principle can be applied because there are comparable third party transactions then the situation should be relatively straightforward. The contractual incentives and functional analysis determine the relationship between connected parties, in particular the allocation of risks between them. Depending on how the risks are allocated, and the contractual incentives between the connected parties, moral hazard may exist.

   Where the conditions differ between connected parties, for example a decision to centralise the management of risks, then commercial principles can be applied, using economic principles, to establish whether there is a genuine business motive. Where there is none, and the motive is purely tax avoidance, then the profits should be reallocated on the basis of normal commercial
Where risks are centralised in order to obtain economies of scale, and the central location enjoys a higher level of remuneration because of the higher level of risk, the transfer pricing should follow accordingly. However where, notwithstanding the centralisation of risk, local subsidiaries that do not have the ability to control risk take a tax deduction for resulting losses, then the transfer pricing should be adjusted to reallocate those losses to the sites where the relevant risks have been managed. In the case where arrangements do not follow rational commercial principles because of poor management control, or other reasons that do not include tax avoidance, the position becomes more complex.

An example where moral hazard may exist is when there is an incentive scheme in place which rewards employees on the performance of the subsidiary they work in. If there is a misallocation of risk/reward and imperfect information, moral hazard may exist such that an employee will aim to maximise the profits of the subsidiary which may lead to a decrease in the overall profits of the multinational enterprise (MNE). This may arise when the subsidiary cannibalises the profits from another entity in the group leading to an overall decrease in profits of the MNE.

2. The observation that unrelated parties may be unwilling to share insight about core competencies, for fear of losing intellectual property or market opportunity, may mean that two independent parties would not enter into such a transaction. Consequently suitable uncontrolled transactions will not be available.

However the mere fact that uncontrolled transactions do not exist does not mean that controlled transactions have taken place other than for genuine commercial reasons. Nor that the arm’s length principle cannot be applied. In the same way that financial economics can produce suitable adjustments to a CUP, we feel that an analysis using financial economics (or microeconomics) is likely to establish an equivalent arm’s length price, under rational economic principles. Secondly, such an analysis is likely to identify where a transaction has not taken place for genuine commercial reasons at all and therefore non-recognition might be appropriate.

3. We do not agree that the exploitation of an intangible, as set out in the example in paragraphs 90 and 91 (and the latest Intangibles Discussion Draft), is fundamental to the value creation of an intangible. In our view intangible value should be limited to development, enhancement, maintenance and protection functions. Also we do not agree that the transaction would not have taken place between independent parties because it gives a post-tax positive return but a negative return before tax. Investors undertake transactions based on the value arising from expected cash flows including taxation. It seems that in the example given if the subsidiary S1 is in a worse position after the business arrangements are modified, this is probably because it charged company S2 too low a lump sum payment in consideration for selling its trademark.

4. Under the arm’s length principle, transactions between associated enterprises should be recognised where the sole effect is to shift risk. An example of an arm’s length transaction where the sole effect is to shift risk is a transaction between a bus company and an unconnected insurance company whereby the risk of costs arising from accidents is shifted from the bus company to the insurance company. For the transfer of risk from one agent to another agent, the premium paid will depend on the level of risk transferred and other contractual arrangements. The relevant conditions for this to apply between associated enterprises are that the enterprise receiving the risk should have sufficient functionality to be able to do so.

5. In the example in paragraphs 90 and 91, the transfer of an asset from Company S1 to Company S2, significantly increases the risk of Company S1. This is because there is uncertainty in the amount of royalty fees that Company S2 will charge to Company S1. In addition, there is a significant increase in risk to Company S2 because Company S2 does not exploit its own trademark. Apparently it relies on the functions carried out by Company S1 to enhance the value of its trademark. If there is a decline in the quality of the product produced by Company S1, the value of trademark owned by Company S2 may fall. In practice it is likely that commercial parties would add protection against these risks under the terms and conditions of the contract for the
sale and subsequent use of the asset. The fact that in an individual situation the terms and conditions actually in place between associated parties do not follow commercial reality, does not mean that all such transactions should be recharacterised.

6. The transfer of the asset leads to an increase in risk for both Company S1 and Company S2. Since both parties suffer an increase in risk, both parties would require a higher expected return to compensate them for the additional risk. However if returns are expected to be constant the parties would not be able to achieve this unless one party has a stronger bargaining than the other. The risk reward preferences of economic agents will vary. It is normal for agents of different risk reward preferences to come together to agree a contract of mutual benefit. However where two parties both reorganise their arrangements in such a way that they both require higher returns subsequent to the reorganisation this suggests that the commercial nature of the reorganisation should be questioned. In some cases the outcome may be reasonable because the opportunity for one of the parties to manage risk more cheaply after the reorganisation than was available to it beforehand, due to extraneous factors, means that it is in a better position overall. Alternatively a party may be prepared to receive a lower return than no return at all.

7. Under the arm’s length principle, risk-return trade-off does apply in general to transactions involving the shifting of risk. This is because an independent party would usually only accept additional risk when it has been sufficiently rewarded for taking on the additional risk.

The limits to the extent that the risk-return trade-off should apply to two connected parties should be analysed by determining how independent parties behaving in a commercially rational manner would approach such a transaction. If independent parties that behave in a commercially rational manner would not carry out such a transaction because there is no reasoned business case, then the transaction may be treated as one that is not at arm’s length. This may be where the level of risk involved exceeds the level of risk a party can tolerate. Another example where an independent party may not carry out a risk transfer transaction is when there is a mismatch between risk and reward such that the party to which the risk is being transferred is not sufficiently rewarded. This is not the same as saying that because a transaction does not occur between independent parties it is irrational. Nor that it is incapable of being tested by economic analysis.

It is important to recognise that risk appetite varies considerably. An approach that attempts to apply some average or "normalised" risk-reward profile should not be adopted. For example in the open market some bonds, even government issued bonds, may be highly risky, however there are still investors willing to purchase them on a speculative basis. In bond market parlance "investment-grade" risk preferences should not be as seen as the only rational alternative, effectively ignoring "speculative grade" activity.

In order, to reduce tax compliance costs, where value does not warrant such a complex risk-return analysis, there should be a safe harbour regime for less significant transactions.

8. In the case of financial services particular emphasis should be given to risk when delineating the tested transaction. The pricing of most financial services is fundamentally based on the risk versus return principle. It is important that the risks in the controlled transactions are analysed in detail and when selecting uncontrolled comparable transactions, the risks of the uncontrolled transactions are taken into consideration. Economic principles such as portfolio diversification and the capital asset pricing model should be taken into consideration when analysing risks of the controlled and uncontrolled transactions. In fact this should apply in all cases but will be especially important for financial services.
When analysing risk both capital and labour should be taken into account. At a basic level the production function consists of two factors of production: labour and capital. When providing a good or a service both factors of production bear risk and therefore both production functions should be remunerated. It should not be sufficient to analyse the labour functions alone. Instead, all factors of production should be analysed when determining the allocation of risk and expected returns.

Comments in relation to Part II of the Discussion Draft:

Option 1: Hard to value intangibles

It seems reasonable to require taxpayers to document the kind of analysis that independent parties would undertake in approaching the question as an investment decision. The approach to investment appraisal and opportunity analysis taught in most business schools serves as a basis on which to evaluate whether a sufficiently robust exercise has been carried out. There is much literature available, for example in published textbooks and journal articles, from which to determine what is commonly considered to be an acceptable approach. This could be used to evaluate whether the documentation is sufficient, with respect to the materiality of the intangible under consideration.

In our view, a requirement that a supporting analysis should be undertaken in keeping with the type and extent of an analysis that a third party would undertake (according to normal business diligence) is in line with the guidelines as they currently stand. Therefore it seems that to expand further on this guidance is a consistent approach.

For very large transactions a requirement to revisit the analysis periodically, perhaps annually in the case of a very significant transaction, would be a reasonable requirement to deal with the problem of uncertainty. However it must be recognised that business decisions are always made under conditions of uncertainty and any move towards guidance that suggests otherwise would be severely prejudicial to taxpayers.

A variance from expectations by more than a pre-set percentage should only ever be used to trigger the requirement to update the analysis going forward. In our opinion such a condition should never be imposed to adjust prices with retro-active effect. It is only in a market where it is normal practice for contracts between independent parties to contain a variance-based pricing adjustment that such a condition would reflect the economic conditions of normal market practice.

Option 2: Independent investor

If this option is, in fact, considering an analysis of what a rational independent investor would be likely to do under similar terms and conditions, then we would view it as a valid option. The capital asset pricing model and the subsequent developments to the original academic work done in this area offer an objective basis to evaluate conformance with widely accepted methodologies. Modern portfolio theory may serve as a similar standard.

One of the problematic areas is likely to be how to find a consensus on the degree of outsourcing/insourcing of risk management functions that is acceptable. While arrangements between independent commercial businesses should serve as the indicators here, identifying this information in the public domain, on a sufficiently wide scale, may be too burdensome for the individual taxpayer. Consequently, we feel that it would be helpful for the guidelines to provide more insight on the extent to which the performance of risk management functions by a party other than the principal bearer of risk,

1 Land may be regarded as an insignificant factor in most financial services.
should be accepted by tax administrations. It is noted that this guidance may need to vary according to the business sector concerned.

**Option 3: Thick capitalisation**

In our view there is no justifiable reason for imposing pre-determined levels of capitalisation by setting capital ratios. Capitalisation is an area where the arm’s-length principle can be applied and it should therefore be the normal approach. A search can be conducted for comparable companies, for example by activity, industry sector and size, in order to examine the level of capitalisation seen in the market by similar companies. This can be used to determine an arm’s-length range of capital and related financial ratios against which to test. Qualitative considerations should also be taken into account.

Any initiative to impose pre-set capital levels between connected parties would place multinational businesses on a different footing to the market and would be detrimental to international trade. It would also constrain the efficient cross-border utilisation of resources.

It is, however, an entirely different matter to offer a safe harbour alternative for minor capital transactions. This may provide a simplified regime for smaller tax payers. Such a regime should be operated entirely at the option of the taxpayer. Furthermore the safe harbour capital ratios within that regime should never serve as a default that a taxpayer conducting an arm’s-length analysis needs to disprove. Rather, any safe harbour regime should operate entirely separate from an arm’s-length alternative. Some countries already offer this approach.

**Option 4: Minimal functional entity**

In our view the current guidelines already provide a good basis on how to approach this problem. More specific guidance with respect to the question of how to test whether the level of functionality is sufficient would prove a better alternative than developing solutions beyond the arm’s-length principle. Again it is our view that where the transaction is one that simply does not occur between independent parties, then the normal practice and standards employed by most finance professionals in decision-making should be applied.

Rather than introducing arbitrary conditions, such as the mandatory profit split, we would prefer that OECD undertake further work to detail the qualitative and quantitative attributes that relate to specific industry sectors. The work previously completed by OECD on the attribution of profits to permanent establishments serves as a precedent here. Parts 2, 3 and 4 of that guidance dealt with three business specific sectors (banking, global trading and insurance respectively). This has proved to be a useful common standard for analysing the activities concerned. It also provides guidance on how the arm’s-length principle should be applied.

**Option 5: Ensuring appropriate taxation of excess returns**

We agree that CFC rules have a fundamental role to play and that they should align with the transfer pricing guidelines. The BEPS project is an ideal opportunity to ensure that alignment is part of the OECD consensus. Our reservations here relate to how the secondary rule, targeting non-taxation may operate.

We believe that the OECD guidance on the attribution of profit to permanent establishments should be used to assess the sufficiency of both functionality and taxable profit in such cases. These may be used to test whether an independent party would have provided goods, services or intangibles to a third party. If that test is met, then a second test should be used to examine whether this independent provision
would have been made on the same terms and conditions as in the connected situation. This would
serve to establish whether genuine commercial benefits have motivated the behaviour or whether it is
based purely on tax avoidance motives. Where either test is failed, and the arrangements are seen to be
for tax avoidance reasons only, then sheltered profits would be reallocated and taxed accordingly.
However, we feel that where these tests are passed, and the arrangements are shown to be for genuine
commercial benefits, then there should be no question of additional taxation being imposed. Certainly not
purely on the grounds that one territory has a lower rate of taxation.

This should be the general principle. However, in the case where the lower tax territory is one that has
not complied with the OECD’s initiatives on unfair tax competition (a jurisdiction that is universally
regarded as a tax haven) then there may be grounds for exceptions. We feel that a supplementary rule to
deal with this should not be imposed until both such low tax jurisdictions and businesses have had
sufficient time to address existing arrangements. It should certainly not be imposed retroactively.

Also there should be no suggestion that OECD member states signing up to the revised guidelines, or
jurisdictions associated with OECD for BEPS, should come within this exception. Also we do not agree
that the average effective tax rate over the preceding three years should be used to measure whether
unfair low taxation has occurred. Instead, the corporation tax rate or the corporate income tax rate should
be used to assess whether a jurisdiction has a low tax rate or not. Where companies take advantage of
tax incentive measures, that countries use to encourage investment, they should not be punished for
following these incentives because they enjoy a lower effective tax rate. If such incentives infringe the
internationally agreed consensus on unfair tax competition this issue should be dealt with between states
in that context. The individual member states concerned should reform such measures, if they are truly
harmful, in order to enjoy the benefits of the OECD/international community.

Should you wish to discuss any of our comments we remain at your disposal. Please contact the
undersigned.

Yours sincerely

Martin Zetter
Head of Transfer Pricing and Senior Economist
on behalf of Macfarlanes LLP

DD +44 20 7849 2945
Martin.Zetter@macfarlanes.com
Dear Mr Hickman

**Actions 8, 9 and 10 (Risk, Recharacterisation and Special Measures)**

Matheson welcomes the opportunity to comment on the public discussion draft issued under BEPS Actions 8, 9 and 10: Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures) (the “Discussion Draft”).

Matheson is an Irish law firm and our primary focus is on serving the Irish legal and tax needs of international companies and financial institutions doing business in Ireland. Our clients include over half of the Fortune 100 companies. We also advise seven of the top ten global technology companies and over half of the world’s 50 largest banks. We are headquartered in Dublin and also have offices in London, New York and Palo Alto. More than 600 people work across our four offices, including 75 partners and tax principals and over 350 legal and tax professionals.

Comments made in this letter are made solely on our own behalf.

1. **Respect for contractual arrangements**

   The importance of actual conduct can be emphasised without undermining the importance of the contractual relationship.

   The proposed inclusion of the first sentence in paragraph 1.53 would severely disadvantage the taxpayer, in particular on audit, where it seems that it would be up to the taxpayer to establish that the actual conduct of the parties reflects the contractual arrangements. This is unnecessarily burdensome for the taxpayer. We recommend that the first sentence in paragraph 1.53 is re-drafted as follows:
“In the absence of evidence to the contrary, it should be assumed that contracts accurately and comprehensively capture the actual commercial or financial relations between the parties.”

We agree that to the extent the conduct of the parties to an intra-group contract does not align with the agreed terms it is appropriate to base pricing on the actual conduct. However, in the absence of evidence suggesting that the conduct of the parties is not in keeping with the intention of the parties, it is unclear why an assumption that the contract reflects the arrangements in practice should not apply.

Furthermore we would suggest that one-off or occasional actions, in most cases, should not be sufficient to undermine the contractual terms for the purposes of pricing. Even under third party arrangements, the parties will from time-to-time deviate from the contractual terms if such deviation is the most practical course of action. However, that behaviour does not infer that the contractual terms are obsolete or have been overwritten, nor does it go to pricing. Therefore, in order to displace the assumption that the contract accurately and comprehensively captures the actual arrangement material divergences from the material elements of a contract should be observed on a consistent basis over a sustained period of time.

2  

Risk

It is appropriate that an entity that manages, controls and / or mitigates risk should, to an extent, be treated as bearing the risk.

We would be concerned as to whether the “moral hazard” concept adds anything to the collective understanding in aligning profits with risks, beyond the process for identification and management of risks as outlined in paragraph 40. In any case moral hazard has no application to those risks that cannot be managed effectively. Under third party arrangements such risks are legitimately allocated between unrelated parties who cannot control them. The risk-return trade-off is usually taken into account in pricing such arrangements. It should be open to related parties to price the allocation of such risks with regard to the risk-return trade-off.

For example, paragraph 60 of the Discussion Draft outlines a scenario where product recall risk is assigned to a distributor (who accordingly is allocated a higher margin). Stringent supplier audit programmes, extensive testing protocols, mandatory training and a culture of improvement is all managed by the manufacturer. The Discussion Draft concludes that as the risk management is actually performed and controlled by the manufacturer, the manufacturer should attract the outcome of the upside and downside risk instead of the distributor.

What if, despite the risk management efforts of the manufacturer, there is a product recall and a substantial claim for damages, all of which is covered by the distributor. Does that change the analysis? We believe that it should. Even though the manufacturer should be remunerated for the role played, the distributor should also be remunerated. Related parties should not be precluded from agreeing on an arm’s length basis where that risk should lie, provided the entity that takes the risk has capacity to bear the financial burden of the risk.
We would note that risk may indeed be shifted within MNEs for good reason. For example, many risk realignment exercises specifically seek to align risk to the jurisdiction(s) where the risk is supported, managed and controlled. This is particularly an issue for MNEs that have undergone expansion through acquisition, followed by consolidation and integration. Indeed, it can be the case that certain entities that historically supported, managed and controlled the risks (while part of a smaller group) continue to earn excessive risk related returns following combination with a larger MNE even though they no longer in fact support, manage and control such risks.

3 Non-recognition should be applied selectively

The Transfer Pricing Guidelines should specifically provide that non-recognition should be treated as a last-resort mechanism for pricing transactions entered into between related parties. Application of non-recognition disregards legal agreements signed by related parties and seems to permit an entity’s separate corporate personality to be disregarded. These are fundamental and well-understood legal concepts. They have the benefit of providing the taxpayer with some certainty in assessing tax liabilities. To the extent contracts and separate legal personalities are disregarded, tax authorities will have a broad remit to redefine legal arrangements as they see fit. Such an approach should be strongly discouraged in the vast majority of cases.

In instances where there are material divergences from the material elements of a contract on a consistent basis over a sustained period of time then non-recognition should be appropriate. Otherwise a robust transfer pricing functional analysis should deliver an arm’s length result.

The example in paragraphs 90 and 91 is perhaps overly simplistic and does not reflect the factual circumstances underpinning decisions taken by MNEs. In this regard the simplicity is most unhelpful. Even a slightly more nuanced example should consider the application of the consideration received by S1. In addition, for an MNE it is likely that the transfer of the trademark to S2 is taking place as part of an operational expansion or reorganisation across a number of regions. The trademark and license to S1 would likely sit beside numerous other trademarks and licenses to various other subsidiaries across the globe. Furthermore, it may have been the case that S1 did not have the capability or desire to jeopardise a successful home business through expansion.

We welcome the acknowledgement in the Discussion Draft that “the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised”. This is an important point for MNEs. However, it is not entirely clear from the Discussion Draft how that statement in practice should be reconciled with the proposed test for when non-recognition may apply – whether the actual arrangements differ from those which would have been adopted by independent parties behaving in a commercially rational manner. We would welcome clarification on this point.

4 Potential Special Measures

As a general comment, there is a significant risk that if the circumstances in which the special measure can be invoked are not clearly set out this will create substantial ongoing uncertainty for MNEs. Uncertainty for business will impact investment and global economic growth.
In particular, on Option 1 we would be concerned that it would only ever be applied to align profit and value creation in cases where the value of the intangible increases substantially (and not where value falls). On this basis while a special measure may with hindsight deliver an apparently more accurate valuation, it is not clear that as a matter of principle it is a better means of valuing transactions. In the commercial world, fixed price transactions are as common as variable or contingent price transactions. Although unrelated parties who contract at arm’s length may believe that a fixed price is fair at the time they enter the contract, with the benefit of hindsight at a later date the same parties may have a different opinion but it will be too late to seek further remuneration. This commercial reality should be reflected in all guidance on hard to value intangibles. Option 1 seems appropriate where there is no contemporaneous documentation.

Thank you for the opportunity to comment on the Discussion Draft. Should you wish to discuss any of the points raised, please do not hesitate to contact us.

Yours faithfully

Sent by email, bears no signature

MATHESON
5 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

Re: BEPS Action 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,

Please read the attached document for my comments on the above Discussion Draft.

I am a Chartered Professional Accountant (CPA, CA) and Chartered Business Valuator (CBV) who has specialized in transfer pricing since 1996, an expert witness in the Tax Court of Canada, and founder of MDW Consulting Inc., an independent firm that specializes in transfer pricing.

I look forward to the public discussion on risk, recharacterisation and special measures.

Sincerely,

Matthew Wall CPA, CA, CBV
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The following comments are provided for the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures).

Part I, Guidance for Applying the Arm’s Length Principle

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By stating the concern, but not the cause, the Discussion Draft might affect a wide swath of taxpayers as collateral damage

Respectfully, the Discussion Draft focuses on Base Erosion and Profit Shifting (BEPS), but fails to mention this is something that commonly involves related parties in low tax jurisdictions.

Page one states the main concerns for Actions 8, 9, and 10 of the BEPS Action Plan, which involve transactions between related parties, and frequently refers to a related party as a group member or entity throughout the Discussion Draft. However, it is careful not to say the main concerns involve a group member in a low tax jurisdiction, or an entity in a low tax jurisdiction. It is not until page 45, the very last page, where for the first and only time, the Discussion Draft clearly and plainly states:

… the BEPS project is fundamentally motivated by the shifting of income intra-group to locations where it is taxed at a low rate or not taxed at all.

If BEPS is the concern, which it clearly is, the Discussion Draft needs to clearly and plainly state the cause for this concern – e.g., related parties in low tax jurisdictions. This needs to be stated more than once, starting on the first page and throughout the Discussion Draft. Only then can we assess the effectiveness of the proposed revisions for addressing the cause for this concern.

By failing to state the cause for this concern – e.g., related parties in low tax jurisdictions, there is a risk that tax authorities might use or misuse the proposed revisions for reassessing transactions that do not involve low tax jurisdictions – e.g., affecting a wide swath of taxpayers as collateral damage. Pages 8 and 9 of these comments include a list of examples taken from the Discussion Draft that do not specifically mention or involve a group member or entity in a low tax jurisdiction.

Respectfully, the OECD needs to stop dancing around this issue, name it for what it is, in order to have a frank and open discussion at the public consultation for this Discussion Draft.

While the OECD appears reluctant to specifically name and deal with low tax jurisdictions, other countries are not, and some are taking unilateral action, like the U.K. with its introduction of a diverted profits tax of 25%, and the U.S. with its discussion of a global minimum tax of 19%.
Rewriting the rules, lowers the standard for recharacterising transactions

Existing Guidelines for recharacterisation

One of the fundamental changes was to remove all of section D.2 Recognition of the actual transactions undertaken including paragraphs 1.64 to 1.69 which, at the heart of it, allowed recharacterising transactions in only two circumstances, as explained below.

1.64 A tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, …

… using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapter II. …

… 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 created where the other tax administration does not share the same views as to how the transaction should be structured.

1.65 However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure …

… The first circumstance arises where the economic substance of a transaction differs from its form …

… The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price …

Discussion Draft for recharacterisation

The Discussion Draft proposes to replace the existing Guidelines for recharacterisation with a new section, D.4 Non-Recognition including paragraphs 83 to 93. Put simply, it appears, this will:

No longer:

i) Require a tax authority to examine the transaction actually undertaken by the associated enterprises as it has been structured by them;

ii) Limit the use of recharacterisation in exceptional circumstances; and,
iii) Require proving the first criteria that the economic substance differs from its legal form.

Focus entirely on the second criteria, which would be the only test for recharacterisation when:

i) The actual arrangements differ from those which would have been adopted by independent parties behaving in a commercially rational manner; and,

ii) The structure impedes the determination of an appropriate transfer price.

The Draft briefly explains what might constitute actual arrangements differ from those which would have been adopted by independent parties behaving in commercially rational manner as follows:

Par. 83 non-recognition [recharacterisation] when the transaction does not have the fundamental economic attributes of arrangements between unrelated parties.

Par. 88 the concept of 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 the OECD Guidelines.

Par. 88 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 it is hard to delineate what independent enterprises behaving in a commercially rational manner would have done.

Par. 88 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.

Closing Remarks

Based on the proposed revisions mentioned above, and other reasons noted on pages 8 and 9 of these comments, the Discussion Draft lowers the standard for recharacterising transactions.

It appears the proposed standard for recharacterisation is based on a new concept referred to as fundamental economic attributes, which is defined by an existing concept known as the commercial rationality test, which the Discussion Draft recognizes in paragraph 88 “is hard to delineate what independent enterprises behaving in a commercially rational manner would have done.”

Further, the Discussion Draft does little to define, explain or illustrate the phrase “whether the structure adopted practically impedes the determination of an appropriate transfer price.”

Respectfully, how is this better, if – in the OECD’s own words – it is hard to define what independent enterprises would have done, and there is no guidance for when a structure impedes the determination of an appropriate transfer price. This does nothing to improve the interpretation of the OECD Guidelines for recharacterising a transaction in a manner that parties will readily understand and accept. It increases the risk and uncertainty of a tax dispute.
Changing priorities, recharacterising transactions based on the conduct of the parties more than contractual terms

Another fundamental change is that the Discussion Draft will allow tax authorities to more easily disregard the actual transactions or substitute other transactions, as explained below.

By removing paragraphs 1.64 to 1.69 from the existing OECD Guidelines for recharacterisation, tax authorities will no longer be constrained by the contractual terms in the existing guidelines.

1.64 A tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured …

Instead, paragraph 3 of the Discussion Draft proposes tax authorities focus on “identifying the commercial or financial relations” based on the “actual conduct of the parties”.

It appears the OECD has relegated contractual terms in favour of the conduct of the parties when paragraph 3 says “written contractual agreements … provide the starting point” for defining (delineating) the transaction based on the parties “responsibilities, risks, and benefits”.

When there are “no written terms” or “contractual terms are ambiguous, incorrect or incomplete”, paragraph 3 defines the transaction based on the “actual conduct of the parties.”

Respectfully, there is a risk that tax authorities might claim (fairly or otherwise) that: the legal language used in the contract is difficult to understand and “ambiguous”; OR, an error or omission in the contract renders it “incorrect”; OR, unforeseen events that occur years later renders the contract “incomplete”; AND, for one or more of these reasons, the tax authority sets the contractual terms aside in order to define the transaction based on the “actual conduct of the parties”.

Paragraph 3 from the Discussion Draft is shown below in its entirety.

3. [New and 1.52] A transaction is the consequence or expression of the commercial or financial relations between the parties, and, as discussed below, the manner in which the transaction has been formalised by the taxpayer should be reviewed in light of the actual conduct of the parties. Where a transaction has been formalised by the taxpayer through written contractual agreements, those agreements provide the starting point for delineating the transaction between the parties and how the responsibilities, risks, and benefits arising from their interaction are to be divided. The terms of a transaction may also be found in communications between the parties other than a written contract. Where no written terms exist, or where 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 based on the review of the commercial or financial relations as reflected by the actual conduct of the parties. [Underlining added for emphasis.]
The guidelines in paragraph 3 are applied in paragraphs 4, 5 and 6 of the Discussion Draft to illustrate when “differences between written contractual terms and conduct of the parties” lead to recharacterising a transaction based on the “capabilities and conduct of the parties”.

Paragraphs 4, 5 and 6 of the Discussion Draft: first considers the contractual terms between the related parties; secondly, identifies differences between the contractual terms and conduct of the parties; and, finally, determines if the differences are sufficient to recharacterise the transaction based on the conduct of the parties. This is consistent with the existing guidelines for recharacterising a transaction in paragraphs 1.64 and 1.65 of the OECD Guidelines.

By first considering the contractual terms between the related parties, paragraphs 4, 5 and 6 of the Discussion Draft are consistent with paragraph 1.64 of the existing OECD Guidelines. Why then does the Discussion Draft remove and exclude the requirement for the “examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises” as stated in paragraph 1.64 of the OECD Guidelines?

Secondly, by identifying differences between the contractual terms and conduct of the parties, paragraphs 4, 5 and 6 of the Discussion Draft are consistent with paragraph 1.65 of the existing OECD Guidelines. Why then does the Discussion Draft remove and exclude “the first circumstance [for recharacterising a transaction] arises where the economic substance of a transaction differs from its form” as described in paragraph 1.65 of the OECD Guidelines?

Finally, by concluding the differences are sufficient to recharacterise the transaction based on the conduct of the parties, it appears paragraphs 4, 5 and 6 of the Discussion Draft are consistent with paragraphs 1.64 to 1.69 of the existing OECD Guidelines. Why then does the Discussion Draft remove all of section D.2 Recognition of the actual transactions undertaken including paragraphs 1.64 to 1.69 of the OECD Guidelines?
Once only in exceptional circumstances, recharacterising transactions might become a routine adjustment

The existing Guidelines include cautionary language requiring “exceptional” circumstances immediately before its two criteria for recharacterising a transaction. It appears the purpose of this term, and its function, is to limit its use for only those situations where a thorough analysis of the facts and circumstances warrants recharacterising a transaction – e.g., a serious matter. Historically, this has been effective, as demonstrated by the limited number of Reassessments and Appeals at the Tax Court that include recharacterisation as one of the issues in dispute.

It is reasonable to expect many more recharacterisations to be included in Reassessments and Appeals at the Tax Court once the Discussion Draft rewrites the rules, including the changes noted on pages 4 and 5 of these comments, which lowers the standard for recharacterising transactions.

Further to this point, the Discussion Draft provides many examples (summarized below) that illustrate opportunities that might lead a tax authority to recharacterise or adjust a transaction.

As mentioned on page 3 of these comments, most of these examples taken from the Discussion Draft do not specifically mention or involve a group member or entity in a low tax jurisdiction.

D.1 Identifying the commercial or financial relations

Par. 6 Subs Co is found to be a service company, not a licensed distributor
Par. 7 Parent Co procured technical assistance for the Subs Co that are not in their contract
Par. 8 Parent Co procured services for the Subs Co that are not in their contract
Par. 12 Options realistically available provide a better opportunity to meet commercial objectives
Par. 17 The capacity requirements might be different for a related vs independent logistics company
Par. 18 The additional capabilities of an insurance provider might lead to a different fee
Par. 22 There are significant differences in the risks between controlled vs uncontrolled transactions
Page 14 Under the arm’s length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk?

D.2 Identifying risks in commercial or financial relations

Par. 60 The risk of a product recall should be born by the party that manages or controls this risk
Par. 62 the risk of stock obsolescence should be born by the party that manages or controls this risk

Par. 63 if the Co owning an asset is not capable of controlling the risks associated with exploiting it, then the Co is only financing the cost of the asset and should be remunerated on this basis

Par. 74 most situations implicitly include risk management in the market price for products or services

Par. 77 a risk management fee is needed if the provider is not in the goods & services supply chain

D.3 Interpretation

Par. 80 formal conditions in contracts are found not to be aligned with the substantive arrangements

D.4 Non-Recognition

Par. 90 Co P restructures by: Sub 1 transfers a trademark to Sub 2 for $400 million; Sub 2 licenses the trademark to Sub 1 for a royalty; and, Sub 2 contracts Sub 1 for marketing services to maintain and enhance the trademark. Sub 2 is in a low tax country with several employees.

Respectfully, the Discussion Draft includes the above list of 15 examples, many more examples than the existing OECD Guidelines, which increases the risk and concern that tax authorities might soon be recharacterising or adjusting transactions on a more frequent and routine basis.

When there are “no written terms” or “contractual terms are ambiguous, incorrect or incomplete”, paragraph 3 defines the transaction based on the “actual conduct of the parties.”

Respectfully, there is a risk that tax authorities might claim (fairly or otherwise) that: the legal language used in the contract is difficult to understand and “ambiguous”; OR, an error or omission in the contract renders it “incorrect”; OR, unforeseen events that occur years later renders the contract “incomplete”; AND, for one or more of these reasons, the tax authority sets the contractual terms aside in order to define the transaction based on the “actual conduct of the parties”.

Finally, page 45 of the Discussion Draft states the “BEPS project is fundamentally motivated by the shifting of income intra-group to locations where it is taxed at a low rate or not taxed at all”, which is the very reason for this Discussion Draft, yet the Discussion Draft includes many examples that do not specifically mention or involve a group member or entity in a low tax jurisdiction. Respectfully, are these examples appropriate given the circumstances, and is it possible that some of the proposed changes in the Discussion Draft have gone beyond the mandate for addressing BEPS?
A wholly arbitrary exercise the iniquity of which could be compounded by double taxation

Paragraph 1.64 of the existing OECD Guidelines says it best, which is worth repeating:

1.64 … 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 created where the other tax administration does not share the same views as to how the transaction should be structured.

Respectfully, while BEPS is a significant concern that has led the OECD to issue this Discussion Draft, the Discussion Draft has not addressed what guidance, examples or controls exist to prevent the consequence of a “wholly arbitrary exercise the inequity of which could be compounded by double taxation”, something the public discussion and revised Discussion Draft needs to consider.

Shifting the burden of proof

Another fundamental change is to shift the burden of proof from the tax authority to the taxpayer.

The existing Guidelines require a tax authority to examine the transaction actually undertaken by the associated enterprises as it has been structured by them, which can be recharacterised in exceptional circumstances, when a tax authority disputes the commercial rationality.

It appears, the Discussion Draft would have a tax authority query the commercial rationality for each transaction, and allow the tax authority to recharacterise the transaction unless the taxpayer successfully defends the commercial rationality of the transaction as being consistent with arrangements between independent parties behaving in a commercially rational manner, since paragraph 84 of the Discussion Draft states “Where the same transaction can be seen between independent parties in comparable circumstances, non-recognition would not apply.”

Respectfully, how is this better, if – in the OECD’s own words – paragraph 88 of the Discussion Draft recognizes “is hard to delineate what independent enterprises behaving in a commercially rational manner would have done.” Perhaps this is an unreasonable test for both parties, the tax authority and taxpayer, easily argued by one and denied by the other, an unresolved dispute.
Andrew Hickman,
Head of Transfer Pricing Unit,
Centre for Tax Policy and Administration.

OECD Centre for Tax Policy and Administration

February 6th, 2015

Comments on BEPS actions 8, 9, 10: Revision of Chap I of the TP Guidelines (risks, recharacterisation and special measures)

Dear Andrew,

MEDEF is pleased to provide comments on the Discussion Draft “Revision of TP Guidelines” issued on the 1st December (hereafter “the draft”).

French companies consider OECD’s work in general and BEPS Action Plan in particular as crucial if it is to provide a fair, competitive and coherent global fiscal landscape. The forthcoming changes are numerous and will have a gigantic impact on the running of their business. Companies are in the best position to identify difficulties related to implementation, to give feedback on the practical feasibility and to geographically and temporally assess the OECD proposals.

They believe, however, that the operating mode, process and time-frame are inadequate to ensure a full and comprehensive analysis of the draft submitted for consultation. They regret the strengthening of this trend which will be detrimental to all: companies and Governments.
While tracking aggressive tax optimisation, the BEPS exercise should preserve certainty, predictability and feasibility for the benefit of both the business and the tax administrations.

The draft introduces long considerations on the analysis of risk while introducing several new concepts which seem to make the issue more complex for both business and the tax authorities.

New concepts should be introduced only if:
- They come from a direct necessity
- They have a clear and unambiguous definition
- They offer real clarification to the issue
- They can be explained and justified in the transfer pricing documentation in a simple and efficient way
- They are applied in a consistent way by tax administrations

The extended comments on risks are intended to clarify and complete the very good text included in chapter 9 in 2010. We have the impression that the draft does not bring the expected clarification and that the new concepts introduce complexity.

Besides, MEDEF does not see how the redrafting of Chap I will help tackle base erosion and profit shifting. This draft goes far beyond that. We therefore wonder if it should be presented as part of the BEPS action Plan.

We hope our contribution will give you a clearer insight into our expectations and remain at your disposal for further information.

Yours sincerely,
Vanessa de Saint-Blanquat
General Comments

Part I
Interaction of the global value chain with the transfer pricing analysis

The Draft (notably Par 2, 48 and 79) introduces a dependence of the transfer pricing analysis with the global value chain. We agree that analysing the global value chain of a Group is very useful to understand the business and its strategy as well as the logic behind the allocation of functions and risks which are key in the setting up of a transfer pricing policy. However, we question whether this global value chain should be part of every single transfer pricing analysis. It should help set the framework. Transfer pricing is about analysing transactions between two entities linked by a specific arrangement in particular circumstances and that should be the basis of the functional analysis.

Giving too much significance to the value chain to the detriment of the actual transaction to be priced could lead to inconsistencies between MNEs with different integration profiles. For instance, there is no reason to have different commodity prices depending on whether the MNE selling the commodity is fully integrated or not. What matters is to perform a functional analysis and to remunerate the functions, risks and assets properly whatever the size and scope of the whole Group. Logically when a related marketing entity buys a related producing/generating entity from a commodity at a CUP price this latter should not be influenced by the value chain of the MNE as opposed to another. But if the marketing entity does not bear for instance the price risk but only the counterparty risk this could influence the pricing method (CUP could for instance be replaced by TNMM). So it is the functional analysis which prevails over the analysis of the global value chain.

In addition, value chain evolves in time without implying modifications in every single transaction between associated entities.

Finally, involving value chain in the analysis of functions and risks for a specific transaction will raise practical difficulties and complexity in preparing documentation.

Identifying commercial or financial relations

Par 5: we understand the logic of looking at the conduct of the parties. However since it is a highly subjective test and risks leading to a reversal of the burden of proof whereby the taxpayer will need to justify all his acts, we believe that it is tremendously important that a recharacterisation should only happen in case of a substantial deviation between the contract and the conduct. “Where the conduct is not fully consistent with contractual terms” should bear this interpretation.

We would like to emphasise that tax Administrations should not deduce from the fact that related parties have contemplated different arrangements before electing the most adequate, all facts and circumstances being taken into consideration, that there is a presumption of misalignment between arrangements and facts. What matters is that once an arrangement is chosen, the conduct of the parties is consistent. With third parties it also takes a long time before the final arrangements are
reached and tax factors may influence the design of the final arrangement (negotiation...). The same should then also be acceptable among related parties.

Par 12: It is indeed logical to analyse alternative options for each party to a transaction. However we need to take into account the fact that a Group’s interest could exist and justify a solution that might not be the best, in the short term, or as such for a party, but could be justified on a longer term basis, or for reasons other than the mere transaction under analysis. What matters is that the local decision benefits the entity and does not unduly benefit another entity in a significant and repeated way.

Functional analysis

Attribution of functions to a separate legal entity, which is a common reality in MNEs for organisational, geographical and historical reasons, is presented under a concept of fragmentation and conveys an image of voluntary dispersion. Multiplicity of entities with their functions is just a fact even if it raises issues in transfer pricing. However the use of this concept is not very clear as the draft draws our attention to the necessity of determining who is coordinating the whole thing but without any guidance as to how we treat it.

Par 21: the situation described (i.e. fragmentation of activities + coordination) does clearly happen in MNEs and indeed entails difficulties in determining proper allocation of remuneration. It would therefore be very helpful to have more details in the OECD guidelines on the outcome. What would be the remuneration of the coordinator (service or profit sharing)? Who is the key risk-taker that should get the return?

Several entities could perform a control function so control should not be the only criteria otherwise many risks will be allocated to the ultimate parent which is probably not the right answer. There are some answers in par 77 that we believe are a good start but more examples and details could be useful.

Example: when an investment is made at a business line’s level it is not because the corporate functions has validated it (and that the BU was not allowed to do it without the Group’s approval) that the return (profit or loss) should be allocated to the corporate entity.

Example: it is frequent that risk policy be designed at a corporate level and applied by business lines. From a transfer pricing point of view, the Corporate should not be taken for responsible for the outcome of the implementation of this policy as long as, locally, the persons engaging the entity have the power and capacity to oppose the policy in case of mismatch with the interest of the local entity implementing the policy. This does not mean that the Group policy needs to achieve the best result for each local entity. A Group could for instance decide to have a certain level of exposure to a currency, to interest rates, to a commodity, or to have a certain liquidity and ask its members to respect these guidelines as long as the latter can also be justified locally from a business standpoint. It is not rare to have discussions with tax authorities regarding the remuneration of cash deposited in
a cash pool entity. If the Group policy is to be liquid and to limit the deposit of excess cash to 6 months for instance, it will not be possible for the cash pool entity to remunerate the related entities with a 12 month rate even if the latter deposit their excess cash for 12 months. So Group policy may have an adverse impact on the remuneration but if the concern of the Group leading to the risk policy principle is legitimate it should also be legitimate for the local entities.

On risk

In the draft, the counterpart of risk taking is presented as a mere financial return most often in the short term. This is not giving the whole picture of what the firms tend to do. The counterpart is not only immediate profit, but also the presence in some regions of the world, a first ranking in a specific industry, just surviving in specific circumstances, image, etc., which will not necessarily result in financial terms even in the long run.

Identifying risks in commercial or financial relations

The example developed and questions raised in par 39 & 40 are interesting and need to be addressed further in the OECD guidelines since MNEs frequently face the difficulty of risk allocation and subsequent remuneration due to the multiple level of stakeholders intervening in a major decision process.

If the Risk function is centralised and local entities take their decisions within the framework set up at group level and transact with other related entities within the group to apply the policy who should bear the return for the risk taken?

We believe that the entity deciding to apply the group risk policy and transacting should get the return and the risk management team paid a service fee computed on a cost + basis (par 77: not very high value but more than routine and so a margin from 7 to 12% could be appropriate).

Shifting a risk could be a legitimate transaction if the party taking the risk is adequately equipped (resources) and capitalised to take the risk. It is very frequent for activities where centralisation could reduce the risk by itself by allowing netting positions or when it is preferable from a risk management perspective to have a global view and management.

Example: a centralised treasury entity (group members transact with this dedicated entity to hedge an interest rate or a currency risk), a centralised trading entity (generation or marketing entities could transact with the said entity to manage their commodity risk or to optimize their positions on the market on the liquid horizon), a dedicated insurance company...

‘Risk management’ & ‘risk control’

‘Risk management’ is defined by three features, the first two being the definition of ‘risk control’, which seems slightly confusing.
One should be aware that, unfortunately, ‘risk management’ already has a precise meaning in business: it consists of making periodic review of the risk existing in an enterprise ranked by probability and by amounts at stake, with the remedies effectively adopted and the residual risks in the same ranking. It is a corporate job complementing the work on consolidation.

In the banking industry, risk has a specific status as it is the core of the business itself. Risk management is about setting the rules of the bank, risk control being the day to day risk taking on particular customers.

This means that the draft should clearly define what is meant by risk management and risk control because it is contradictory with the actual definitions used by business.

Par. 56 mentions that “risk management may be carried out at several levels”, which could mix the above business definition with the intended definition for risk analysis use.

In the draft ‘risk management’ appears to be linked to the capability of one entity to assume the associated risk but, surprisingly, it is regarded as a kind of service in § 57: “if however the manufacturer manages the risk, then it is performing risk management, for which it should be rewarded”. This requires clarification.

Moral hazard

The new concept introduced in the draft seems to have a negative aspect as it refers to a risk assuming that it would barely be seen between independent parties. We doubt that introducing such a new concept is actually necessary in order to analyse the way related parties behave as compared to independent ones. As it is more a point of questioning than real guidance we would suggest not employing it.

Interpretation and fragmentation

The transfer pricing analysis should absolutely start with the analysis of the legal arrangements and facts and it is only in exceptional cases - i.e. abusive cases - that tax administrations could be entitled to disregard the arrangements when the conduct is significantly unaligned with them.

Therefore, the following extracts from par 82 & 84 are key and should absolutely be applied by tax administrations:

“Importantly, the mere fact that the 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 the fundamental underlying basis of the arrangements that matters, not whether the same transaction is observable between independent parties”

“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.”

“Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognized. 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. The key question is whether the actual transaction possesses the fundamental economic attributes of arrangements between unrelated parties, not whether the same transaction can be observed between independent parties.”

**Concept of ‘fundamental economic attributes’**

Par. 88 & 89, present a concept of ‘fundamental economic attributes’ linked to “whether the actual arrangement differs from those which would have been adopted by independent parties behaving in a rational manner”.

The issue is not new and, as we are reminded in the same sentence, the test is challenging (‘controlled parties do enter into arrangements which differ from those adopted by independent parties’), so that the creation of a concept, which would be regarded as a practical tool for analysis can be misleading.

The danger materialises in par. 93 in case of non-recognition as the draft gives the tax authorities the guidance to replace the non-recognized structure by a new structure on the basis of this ambiguous concept of fundamental economic attributes'.

We consider that Par 89-92 might be difficult to reconcile with the fact that MNEs may prefer to separate the functions between several entities mainly for management purposes.

Ex: an entity active in the production of goods could be interested in developing the marketing and sale activity to benefit from the sales margin on top of its production margin. However the group may decide to have generation and M&S activities located in different entities and to fix a price signal between both entities to meet the group strategy.

We believe that it is not because a stand-alone entity could have developed the M&S activity internally that a group should not be allowed to decide to split the generation and M&S activity in two entities as long as the transfer price is in line with the arm's length principle and the functions and risks are adequately taken into consideration to set the price signal between the related entities. In the example, S2 might be in the same country as S1 or a similar one.

**Risk-return trade-off**

The issue is clear but the reference to present value raises questions. Computing the present value of a sequence of annual cash flows implies the determination of those cash-flows. If there is a doubt about the figures because of uncertainty then several present values should be computed according to different hypothesis (from full success to failure). Then it all depends on the hypotheses and the
respective weight they are given, which is a subjective exercise whose utility in the draft is not obvious to us.

Part II

Option 1: hard to value intangibles

We believe that two issues must be distinguished:
- The valuation of an intangible on the day it is sold or transferred
- Its future value once exploited by the purchaser

In a common sale the seller does not pretend to benefit from the future increase of value of the sold product/asset.

A typical exception can be found in the LBO sector where sales agreements on the transfer of shares mention explicitly that the seller may be entitled to a share in the capital gains effectively made if the purchaser re-sells the shares.

Another exception exists when there is an identified event that is expected to happen in a short period of time after the sale and which may have a significant impact on the price (e.g. the renewal of an administrative authorisation for a key asset). Instead of postponing the transactions the parties may prefer to move forward and to include an adjustment clause.

We do not think that computing a potential value that depends unilaterally on the action of the purchaser is a general solution to the issue of hard to value intangibles. Adjustment clauses should remain exceptional. Generally speaking, the valuation must take into consideration the facts and circumstances of the day the intangible is transferred and include future considerations when assessing the actualisation rate or through a sensitivity approach.

Option 4: minimal functional entity

The title seems to again introduce a new concept of ‘minimal functional entity’ whose wording is not very clear. There is no abnormality in having entities with reduced functions in an MNE.

The case of entity with no substance should be treated as such.

The draft refers to the new concept of ‘fundamental economic attributes’ that we have commented on above with large reservations, and we think it must not be used.

The recommendation to use a profit split in that case seems inadequate as there are not two entrepreneurs and the interaction with a minimal functional entity will be simple to analyse without triggering the complex profit split method.
BEPS Action 8, 9 and 10: Discussion draft on revisions to chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation and Special Measures)

Comments by NERA Economic Consulting – Pim Fris, Emmanuel Llinares & Vladimir Starkov¹

Dear Mr. Hickman,

In the context of the BEPS Action Plan, Working Party No. 6 of the OECD has released on December 23, 2014, a discussion draft (the “Draft”) of the proposed modifications on revisions to Section D of Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation and special measures), issued simultaneously under Actions 8, 9 and 10 of the BEPS Action Plan.

We wish to thank you for the opportunity to provide comments on this document. Please note that our colleague Pat Breslin is providing a contribution on the rationale behind decision making and risks when dealing with early stages investments.

In particular, we applaud the express introduction of relations between associated parties as the starting point for the application of the arm’s length principle in order to accurately delineate the actual transactions in a transfer pricing context. We believe this will do justice to the text of article 9 of the OECD MTC, and will potentially lift impediments in today’s state of the transfer pricing practice as a result of a too-direct, exclusive transactional focus and too-generic testing of outcomes. As such, we would like to offer the following comments.

1. Par. 1: The key aspects of a comparability analysis

The Draft states:

“There are two key aspects in such an analysis: the first aspect is to 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; the second aspect is to compare the conditions of the controlled transaction with the conditions of comparable transactions between independent enterprises.”

However, there are circumstances where such direct comparison with comparable unrelated parties transactions is not possible.

¹ These comments represent independent views of the authors and do not necessarily reflect the views of NERA Economic Consulting
In such circumstances, it is necessary to identify how unrelated parties would behave under the same set of relations and circumstances. The latter insight is needed all the more because, by nature, a large number of intercompany transactions is not of the type that unrelated parties engage in.

In this respect it may be helpful to refer to what we call the Market Pricing Matrix, which reflects an indication of the most dominant transaction models in different types of relations. It shows the patterns of behaviour of independent parties in price negotiations under different relationships. It can help frame the bargaining position of the transacting parties and assess whether at arm’s length the parties would enter into transactions at the prevailing terms and conditions.

The Market Pricing Matrix can be represented using a two dimensional diagram, where:

- On the horizontal axis, one would see the impact of the relationship on capacity investment. This impact can be either low when there are limited investments required to sustain the relationship or high when there are significant investments required to sustain the relationship.

- On the vertical axis, one would place the nature of the relationship which can be either short term (at the bottom) or long term (at the top).

Then, depending on the impact of the relationship and the nature of the relationship, it is possible to determine the most prevalent transactions models for price negotiations.

![Market Pricing Matrix Diagram](image)

**Impact on Capacity Investment**

An example of a relationship that requires a low investment in capacity and is essentially short term is the relationship between a traveller and any airline company. Whilst there can be significant investments for an airline to maintain a fleet of planes and carry on its business, the
transactional relationship with any single traveller does not require any significant investment on either part.

Arguably, a number of intra-group relationships are essentially long term in nature and may require significant investments in capacity. The Market Pricing Matrix would suggest that in such circumstance, the pricing would be open book / transparent between parties to a transaction or transactions.\(^2\)

At this stage, it is important to stress that the outcome in the table above do not have a direct implication on a preference in terms of transfer pricing method for testing purposes. Namely, the open book transparent outcome does not mean that the profit split method will be selected in these situations.

In similar circumstances, it is through bargaining analysis that conclusions have to be reached regarding the arm’s length nature of conditions for transactions. It is by way of a value chain analysis that the respective bargaining positions of the relevant parties to a transaction can be assessed. The explicit introduction of value chain analysis can be seen as the fruit of the BEPS Action Plan imperative that “rules to be developed will also require alignment of returns with value creation.”

2. Par. 2: The role of contractual terms

In line with the Draft, we are of the opinion that giving priority to contractual terms for transactions or dealings between related parties may be counterproductive as an analytical process approach in many if not most cases. It is indeed, as the second sentence of par. 2 states, the conduct of parties as it follows from a functional analysis, augmented by a value chain analysis, which would reveal the relevant starting point. This observation finds its confirmation in the reservations expressed in the Draft repeatedly, as can be seen in the examples in pars 4, 5, 6, 7 and 8. This is why we recommend that, in par 10, the contractual terms of the transaction would be presented as the last of the five comparability factors, as the relevance or appropriateness of related-party contracts can only be judged in light of the preceding ones. Placing it first might be seen as an encouragement to “structure reality through contracts” rather than seeing contracts as a confirmation or documentation of reality and, we think, would weaken the strong message that the OECD has been conveying through its latest publications, that economic substance should override contractual arrangements whenever the latter are not aligned on the former.

3. Par. 12: Options realistically available

We do believe, as pointed out by the OECD, that the consideration of the alternative options realistically available is a vital one and should be paramount to all transactions analysis.

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Transactions follow from the relational context which should be dealt with holistically, after having been reflected as per the value chain analysis and the other comparability factors.

An essential part of the expression is the word “realistically”; it refers to the broad circumstances of the case at hand, and includes elements like imperfect knowledge and availability of information. As such, we would suggest inserting the word “realistic (ally)” every time those available options are mentioned.

4. Par. 16: Functional analysis

It is stated in par. 16 of the Draft that

“In particular, 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.”

Enabling this understanding is the essential contribution of value chain analysis. We encourage the OECD to be more explicit about what value chain analysis encompasses and what distinguishes it from functional analysis as it is reflected currently in the Transfer Pricing Guidelines. We believe that the holistic starting point would be one of the distinctions.

As a side remark, we note that sections D.1.1 to D.1.4 deal successively with the comparability factors whilst remaining silent about contracts.

5. Section D.2: Risks and responsibility

Par. 36 states

“Identifying the risks included in commercial or financial relations is a critical part of a transfer pricing analysis.”

We recommend adding “…risks and the allocation of responsibility for those risks …” Indeed, in line with the OECD thinking as developed in this Draft, what we think is essential to a proper transfer pricing analysis is not only identifying the risk itself, but the allocation of the responsibility for managing it. Dealing with the risk, i.e., with the impact of uncertainty, requires the necessary capabilities and funding.

We are convinced that an effective way to map the allocation would be to use the so-called responsibility profiles as developed for management control purposes. These profiles (investment centers, profit centers, revenue centers, cost centers, expense centers) provide for a meaningful indication of roles and responsibilities in a way that descriptive terms like manufacturer, distributor, etc. cannot. In line with this, we recommend, instead of speaking of “allocation of risks”, to refer to allocation of responsibility for risks. This recommendation may also concern the remainder of the draft.
6. **The additional points (page 13 to 15 of the Draft) (1)**

We think that taking the above recommendations into account should hopefully help answering some of the questions raised in this section:

- Considering the intra-group contractual arrangements at their right place,
- Introducing the responsibility profiles,
- Distinguishing a third aspect in comparability analysis, in combination with,
- The extension of functional analysis by a value chain analysis,

should allow for an improved practical application of the arm’s length principle.

7. **The additional points (2): Moral hazard**

As identified in the Draft, we believe the consideration of moral hazard to be one of the trickiest aspects of transfer pricing indeed.

First, we would like to point out that moral hazard does exist in practice within MNEs. As such, existing incentive mechanisms within MNEs (bonus schemes for managers for example), may turn out to be a relevant indicator of where effective control lies. For this reason, we believe that control and risk are tied – as pointed out by the OECD notably in Chapter IX of the Guidelines.

Yet, we agree with the OECD when it writes in its Draft that moral hazard may be more limited within MNEs compared with the marketplace. This could be one of the reasons for the common existence of transactions within groups that are typically not seen between third parties.

As regards the extent to which “contractual incentives [should] play in the allocation of risks”, we would like to observe that,

- Contractual incentives between unrelated parties, as comparable points, may be useful references as part of a comparability analysis. In essence, in order to provide incentives, contract need to remunerate each party in light of the value it has created. This is what the arm’s length principle implies. Hence, the fact that moral hazard should be reduced in an intra-group context should not be an argument for not using third party contracts as possible references.

- We do not think contractual incentives in intercompany agreements should necessarily or systematically be taken into account in transfer pricing analyses. First, it could be that the managers of the MNE entities are not evaluated on the basis of the intra-group agreements. In such a case, the agreements do not provide real contractual incentives. Second, as made clear by the OECD in its Draft, what matters is the actual conduct of the parties: for instance, in some cases, one could argue that the entity that should be
rewarded for risk management is the one that actually manages the risk and not any other entity that is contractually responsible for or exposed to the risk.

8. The additional points (3): Risk-return trade-off

As economists, we believe that risk-return trade-off is an acceptable concept. As such, it is one of the foundational grounds of the Finance Theory (e.g., the Capital Asset Pricing Model).

Risk transfer as part of risk management occurs routinely between third parties (through financial instruments) or within MNEs, for operational reasons: the centralization and streamlining of risk management, or the rise of the Chief Risk Officer in the C-Suite is a trend widely observable among MNEs. Hence we believe that no prescriptive limit should be applied to risk-return trade-off or risk transfer transactions.

We certainly acknowledge that this type of transaction does have a potential for BEPS, but more generally economic analyses are not immune to “manipulation” from malevolent taxpayers. The answer may only come from more robust and accurate economic analyses. Special measures or prescriptive regulations could trigger more uncertainty, regulatory burden, complexity and even BEPS potential. They are not needed.

As regards the ability to transfer risk without control, we would tend to believe that such transfer can only make sense if consistent with the results of a value chain analysis: if an enterprise were to transfer strategic risks, it would probably mean that it would change drastically its business model. Such transfer of risk may seem unrealistic without transfer of control for the risks or significant changes in the organization.

Please note that, as a principle, we would not advocate for specific rules specific to any industry (no ring-fencing) such as the financial industry, which abides by the same economic principles as other industries do. Rules or guidance not applicable to a particular industry might be the hint of an inner flaw in the underlying concepts of such rules or guidance.

9. Section D.2.1: Categories of risk

We praise the many clarifications brought by this section to elaborate on the nature and sources of risk. We think it does represent a considerable improvement to the previous risk section in the Transfer Pricing Guidelines. However, we believe that the draft could be further completed and amended as suggested below:

- Par. 41, 6th sentence, speaks of “downside risk”; we would suggest replacing with “downside impact of risk.”

- Par. 42 gives a list of sources of risk, as a “relevant framework in a transfer pricing analysis”. By calling the list “non-exclusive” and denouncing any intention of suggesting a hierarchy of risk, the draft steps away from any analytical pretention of the list. This
commands the question what the use of this categorization is. Point is that the impact of risk differs for each category of risk.

- a) Strategic risks are regarded as similar to marketplace risks, and consequently as an externally driven phenomenon. We would not support this view. Indeed, we would tend to believe that strategic risks would be for instance the trigger for the decision to go for a certain industry, market and product range. But the decision on how to implement those choices in practice, designing the business model, deciding which capabilities to build, what intangibles are relevant and how to develop the human capital is not external. All those issues require managing internal challenges. Consequently we think that two options would be possible: either include the intellectual (including human) capital (IC) risks in the strategic category, or distinguish them as a separate category.

- b) The aggregation of operational risks with infrastructure risks should be further thought about.

- d) The introduction of a category “transactional risks” is intriguing. We believe those risks are rather the materialisation, or implementation consequences, of decisions regarding the strategic, IC, operational and/or financial risks. Therefore, we would suggest that transactional risks are taken out of the list in the Draft.

10. Section D.2.2: Allocation of responsibility for risk

As discussed previously (see point 2. above), we don’t think that starting with contracts would send the right signal. We’d rather advocate for the following sequence:

- Identify (through the VCA) the allocation of responsibility for risks;
- Use responsibility profiles to confirm role and responsibilities of entities;
- Only then, look at contracts as the confirmation.

11. Par. 82: Introducing the “fundamental economic attributes”

The Draft introduces a new term of art, the “fundamental economic attributes” of arrangements between unrelated parties. We would advocate avoiding any new terms.

As a matter of fact, the concept of “fundamental economic attributes” is the opening concept to the brand new section, D.4. which notably develops that:

“Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised”.

So, what does? Section D.4.1 seems to give the drafter’s perception of why there is a need for non-recognition. It appears that this has to do with the ability of MNE groups to create and
control “the environment in which transactions occur”. MNE groups have “freedom to control their structures, including shareholding, capitalization and legal form”. Par 86 goes on to say that “Structures based on multiple separate legal entities allow for separate legal ownership of assets, and location of activities and risks according to contracts between the separate legal entities.”

In this perception, there is no place for the idea that enterprises in the first place try to be successful in carrying on their business, and then achieve continuity therein. That requires designing a business model that meets challenges from the risk categories discussed above. Legal structures of enterprises are dictated by their business models, which have to take into account the operational requirements, and market and geo-political realities. The last two types of requirements don’t always coincide. Therefore, we would we recommend to reconsider the language and underlying principles of section D.4.1.

12. D.4.2: What now?

In our first comment here above, we have suggested to distinguish a third aspect in comparability analysis, i.e., to identify how unrelated parties would behave and set conditions for transactions in circumstances that do not allow the identification of (conditions of) comparable transactions between independent enterprises.

It is our opinion that, enabled by the imperative of alignment with value creation, this third aspect would take care of most of the concerns which drive the non-recognition propositions in the draft.

On this particular point, the central concept of value creation makes explicit that the notion of value has always been an essential element in order to achieve a correct application of the arm’s length principle in transfer pricing. As such, we would recommend that a next version of the Draft becomes more explicit about the concept of value, and consequently value creation, with value chain analysis as an analytical tool. In this respect, we think that sections D.6 to D.8 included in the Draft for convenience might deserve reconsideration as a result of a better understanding of drives and constitutes “value”.

Pim Fris, Emmanuel Llinares, Vladimir Starkov
London / Paris / Chicago
February 2015
February 5, 2015

Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Andrew Hickman, Head of Transfer Pricing Unit
2, Rue André Pascal
75775 Paris, France

Re: Comments on Discussion Draft on BEPS Actions 8, 9, and 10: Risk, Recharacterisation, and Special Measures

Dear Mr. Hickman:

The National Foreign Trade Council (the “NFTC”) is pleased to provide written 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), published December 19, 2014.

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project. A list of the companies comprising the NFTC’s Board of Directors is attached as an Appendix.

This letter is divided into three parts. The first part provides general comments and observations regarding the Discussion Draft as a whole. The second part contains specific comments regarding the proposed revisions to Chapter I. And the third part provides comments on the proposed special measures.

In general, the NFTC is concerned with the language of the Discussion Draft that reflects a significant departure from the arm’s length principle. This departure can be seen in the proposed revisions and special measures, as well as in the draft’s tendency, particularly when discussing risk, to overlook the variety of ways that parties at arm’s length routinely engage with each other. While the Discussion Draft states generally that tax authorities should respect
arrangements as formalized in written agreements and recharacterize them only in exceptional circumstances, this sentiment is lost in the specific language of the draft and in particular in the examples. If adopted, the proposals in the Discussion Draft would impose heavy burdens on multinational enterprises (MNEs) even under circumstances where the risk of BEPS is low, unduly complicate the work of tax authorities, create substantial uncertainty, and lead to a proliferation of disputes. Consequently, the proposals fall short of their goal to ensure that transfer pricing outcomes are in line with value creation.

General Comments

The NFTC commends the OECD for addressing the important issues raised in the Discussion Draft and appreciates the opportunity to provide comments on the draft. Our primary concern is that some of the revisions contained in Part I of the Discussion Draft represent a substantial erosion or abandonment of the arm’s length principle, the international transfer pricing standard.

In particular, this departure from the arm’s length principle can be seen with respect to the guidance on “identifying risks in commercial or financial relations” (D.2) and the guidance on “non-recognition” (D.4). Each of those sections of the draft has assertions and conclusions that are at odds with the arm’s length principle. The guidance on the identification of risk essentially mandates that business risks be allocated to the affiliate with functional control over the risk, without regard to the provisions of a written legal agreement or the observed behavior of parties acting at arm’s length. The guidance on non-recognition adopts a “commercial rationality” standard that would disregard transactions that have been actually undertaken based on a subjective determination by a tax authority that the transactions were not expected to enhance the commercial position of the parties. Taken together, these proposals would lead to tremendous uncertainty and a proliferation of disputes in all but the simplest fact patterns, are wholly disproportionate to the concerns identified, and, most importantly, are inconsistent with the arm’s length principle.

The arm’s length principle provides a common international framework that appropriately evaluates the pricing of the vast majority of transactions between associated enterprises. Pursuant to this framework, written agreements between associated enterprises should be respected unless they are fundamentally inconsistent with the underlying substance of the transaction as evidenced by the conduct of the parties. Every effort should be made by tax authorities to price transactions actually undertaken so as to prevent the disputes and double taxation that would invariably result if two or more jurisdictions characterize transactions in different ways.

If individual countries are concerned about particular results stemming from a misapplication of the arm’s length principle to transactions that pose a high risk of BEPS, then the Transfer
Pricing Guidelines should be clarified so as to prevent a misapplication of that principle. In this regard, it may be more appropriate to articulate the current guidance regarding the non-recognition of transactions in the context of those posing a high risk of BEPS, rather than provide for general principles that are contrary to the arm’s length principle.

We also have concerns about the level of scrutiny expected to be applied to transactions, in particular transactions formalized through written agreements. Ex-ante written agreements should be encouraged because they benefit both MNEs and tax authorities. Written agreements establish a starting point (and, in most cases, an ending point) for the terms of a transaction and prevent both taxpayers and tax authorities from recharacterizing transactions based on hindsight or post-hoc rationalizations.

To the extent the goal of aligning returns with value creation can be achieved within the construct of the arm’s length principle, the OECD should strive to do so. Interpreting the arm’s length principle beyond recognition, however, adds uncertainty and will result in double taxation and disputes. Other BEPS Action Items, implemented through changes in domestic legislation or tax treaties, should be considered as a means to mitigate results obtained under the arm’s length principle that are considered unacceptable as a policy matter.

With regard to special measures, the NFTC is very concerned with the breadth of the proposed measures, the lack of clarity around the circumstances in which they might apply, and the resulting potential for double taxation and disputes. To the extent necessary, targeted special measures are preferable to an abandonment of the arm’s length principle because special measures would require changes in domestic law or tax treaties, thereby affording a more appropriate and proportional process given the changes being considered. It seems premature to consider these special measures, however, until work on other BEPS Action Items has progressed, the need for special measures can be accurately assessed, and appropriate special measures targeted toward that need can be developed.

Specific Comments

D.1 – Identifying the commercial or financial relations

The language in section D.1 of the Discussion Draft is intended to provide general guidance on identifying and characterizing transactions between associated enterprises (i.e., “delineating” such transactions). We agree that a written agreement is the starting point for such analysis, and that some level of review by tax authorities may be appropriate where the conduct of the parties is inconsistent with the terms of such an agreement. See ¶ 3.

However, the analysis required to properly delineate a transaction under the Discussion Draft will be burdensome and unwarranted in the vast majority of cases. While we agree that a
written agreement should provide the starting point for delineating the transaction, the remaining pieces of the analysis to determine the commercial or financial relations of the parties require a high level of scrutiny and detailed analysis. For example, the process of identifying and analyzing the economically relevant characteristics or comparability factors referred to in ¶¶ 9-10 will be burdensome and subjective, leading to uncertainty and disputes. Similarly, the need to take account of the economically relevant characteristics of options realistically available requires a level of scrutiny and analysis unwarranted in most circumstances. Because such a robust analysis is not called for in most cases, safe harbors or presumptions in favor of recognizing transactions consistent with the underlying written contracts should be articulated for transactions that do not present a significant risk of BEPS.

Moreover, the proposed guidance seems to permit tax authorities to recast transactions based on conduct that is marginally different from that which is provided for in the applicable written agreements. This will lead to tremendous uncertainty and a proliferation of disputes. The example in ¶ 4, which appears to permit tax authorities to disregard a written agreement because it omitted a reference to a relatively incidental item (i.e., the marketing and advertising activities of Company S), is grossly overreaching and would open up virtually all transactions between associated enterprises to undue scrutiny and recharacterization.

In addition, the tone of the draft is unduly skeptical of written agreements. For example, the draft cautions against assuming “that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties.” ¶ 5. Paragraph 5 generally sets a low bar for tax authorities to disregard contractual terms and delineate transactions on other bases. Ex-ante written agreements should be encouraged as they benefit both taxpayers and tax authorities by establishing the starting point for the terms of a transaction and by preventing both taxpayers and tax authorities from recharacterizing transactions based on hindsight or post-hoc rationalizations. In cases that do not pose a high risk of BEPS, written agreements should be viewed as presumptively establishing the terms of a transaction.

The example in ¶ 6 demonstrates the increased uncertainty and potential for disputes that would arise from allowing tax authorities to ignore written contracts and legal arrangements. In ¶ 6, P licenses IP and provides technical services to S in exchange for a royalty and fee. S uses the IP and technical services in its business. A majority of S’s customers require P to be a contracting party to their agreements. The example concludes that S “does not seem to be operating as a licensee,” but is in fact providing services to P. The questions raised by the example include: (1) what is the basis for recharacterizing the arrangement, and would the jurisdiction in which S operates be bound by the recharacterization; (2) could the royalty and service fee be determined in a manner that reached appropriate results without the recharacterization; (3) under the facts and circumstances, would transactions with customers that did not insist on P as a contracting party be treated differently; and (4) would the recharacterization have non-transfer pricing...
consequences, for example would P potentially have a permanent establishment in the jurisdiction in which S operates.

The Discussion Draft also addresses the circumstance where parties transfer value but do not identify the transaction in a written agreement. See ¶¶ 7-8. This discussion is helpful but needs clarification. The example in ¶ 8 illustrates an arrangement in which certain activities of Company P provide benefits to its subsidiaries but have not been identified as “transactions” by the taxpayer and therefore were not covered by written agreements. The example concludes that “there are commercial or financial relations between Company P and the subsidiaries, which transfer potential value from Company P to the subsidiaries.” ¶ 8. So as to avoid double taxation, it would be helpful if the OECD clarified that, to the extent such benefits are identified, the jurisdictions in which the subsidiaries operate would be required to provide deductions for any service fees deemed paid to P. The failure to provide deductions would result in double taxation.

The extent to which taxpayers should focus on group functions and synergies as compared to the functions of individual entities should also be clarified. In describing the goal of a functional analysis, the draft states that “[i]n particular, 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. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions.” ¶ 16. Paragraphs 16 -21 seem to emphasize a functional analysis focused in part on group synergies, interdependencies, and contributions of each entity to the enterprise. This focus is inconsistent with a simultaneous requirement to evaluate options that are realistically available to an individual entity. See ¶ 17.

D.2 Identifying risks in commercial or financial relations

In General (paragraphs 36-40)

In general, the guidance in D.2 of the Discussion Draft is problematic because it would give tax authorities the freedom to ignore written contracts and allocate risks based on functions, in contravention of the arm’s length principle. Further, the rules would be unduly burdensome to apply to most transactions and would lead to uncertainty and disputes.

The Discussion Draft asserts that, “[i]n identifying the allocation of risk attention should be paid to how the parties actually manage the risk identified. Between third parties, the assumption of risk without the control exerted by management over the risk is likely to be problematic . . . .” ¶ 38. This assertion runs counter to the observable behavior of parties dealing at arm’s length. Numerous contexts exist in which one party at arm’s length agrees to bear risk that is under the control of another party. For example, equity investors in widely-
held companies routinely put their investment capital at risk even though the underlying business risks of the companies are managed and controlled by the management of the companies. Insurance companies routinely agree to bear risks that are under the direct control and management of the insureds. And principals agree to bear risk with respect to the provision of professional or financial advisory services because such risks are often best assessed, managed, and controlled by the service providers. It is not possible to determine a single “natural” or “correct” allocation of risk under the arm’s length principle based solely on an analysis of the relative functions performed by each party to an arrangement.

Moreover, the assertion in ¶ 38 regarding the functional control of risk ignores the role of the management of the parent company of an MNE, which is ultimately responsible for all capital allocation decisions. Even further, directors and senior management are accountable to investors, and such investors ultimately bear the risk borne by an MNE. The control and management of risks may be delegated to managers employed by the parent company, by regional principals, or by the local operating entities. Contrary to the assertions in the Discussion Draft, there is no “natural” way to allocate risk within an MNE. The arm’s length principle provides a very satisfactory framework for evaluating the prices charged among associated enterprises for goods and services actually transferred. That principle should not be interpreted as providing an open-ended license by tax authorities to ignore written agreements or legal entities.

Additional points (Box following paragraph 40)

The Box at pages 12-14 identifies a series of issues, grouped around the terms “moral hazard” and “risk-return trade-off”. The Box begins by questioning whether associated enterprises can be assumed under the arm’s length principle “to have different risk preferences while they may also in fact be acting collaboratively in a common undertaking under common control.”

Under the arm’s length principle, associated enterprises should be assumed to be capable of different risk preferences even though they are part of a single MNE whose purpose is to maximize the profits of the MNE as a whole. We note at the outset that an MNE’s profits are maximized by maximizing the profitability of each of its constituent parts. Further, parties at arm’s length that routinely transact with each other may also be collaborating to maximize the success of the arrangement while seeking to maximize their own returns. Arrangements between a licensor and licensee, or a manufacturer and distributor, may be characterized as collaborative undertakings. The terms of such arrangements reflect implicit allocations of risk that are acceptable to each party based on its own risk preferences. Arrangements among associated enterprises are patterned after such arm’s length arrangements.

A failure to take the different risk preferences of associated enterprises into account would ignore how unrelated parties actually behave and transmute the arm’s length principle into a
framework that looks solely to functions, ultimately leading to a formulary approach. Such a framework would disregard contractual allocations of risk among associated enterprises, including allocations implicit in the ownership of intangibles or other assets. This would represent a fundamental departure from the arm’s length principle and not merely an interpretation within that principle.

Ultimately, the commercial goal of an MNE group is to maximize the revenues and profits of the group. The arm’s length principle is merely a framework for testing the allocation of income among members of the group; there is no inconsistency between this framework and the fact that all associated enterprises are constituent members of an MNE group.

**Moral Hazard**

The Discussion Draft defines “moral hazard” as the “lack of incentive to guard against risk where one is protected from its consequences.” Box at 14. Following this idea, the Discussion Draft poses several questions for consideration. The questions and our comments in response are set forth below.

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 Discussion Draft likely overemphasizes moral hazard as a problem, and it is not necessary to adopt a rule imputing moral hazard to transactions between related parties. It is worth reiterating that contractual allocations of risk between related parties should be the starting point to the analysis under the arm’s length principle. A conceptual approach that imputes moral hazard as part of the analysis under the arm’s length principle is also unlikely to be a reliable proxy for how parties engage at arm’s length. As noted above, there are countless third-party examples where risk is allocated among unrelated parties by contract, and where the party bearing the risk has limited ability to manage or control the risk.

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

This observation should not affect the analysis under the arm’s length principle. Associated enterprises are in fact constituent members of an MNE, and therefore are able to engage in arrangements that would be difficult to replicate among parties at arm’s length. The arm’s length principle has never been interpreted to prevent such arrangements; rather, the arm’s length principle provides a framework for evaluating the pricing of such arrangements. The observation that associated enterprises share information to gain synergies should not be a basis
to depart from the arm’s length principle – gaining synergies by sharing insights is one of the core reasons MNEs exist in the first place.

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

See our comments regarding the example in paragraphs 90-91 below. We do not believe that “moral hazard” should play a role in evaluating this arrangement.

**Risk-return trade-off**

The Discussion Draft similarly poses a series of questions regarding the term “risk-return trade-off” and notes that “[t]he economic concept establishes equivalence on a present value basis between a higher but less certain stream of income and a lower but more certain stream of income.” The questions and our comments in response are set forth below.

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?

Associated enterprises rarely, if ever, engage in transactions solely to shift risk. In general, arrangements have a business context in which risk allocation is one element. Exceptions include insurance and financial transactions such as hedges that are engaged in routinely by parties at arm’s length as well.

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?

All asset transfers for lump sum consideration fundamentally alter the risks assumed by the parties. The seller exchanges the risks associated with the uncertain cash flows expected from the asset, while the buyer assumes uncertain cash flows expected from the asset. Asset transfers occur among parties at arm’s length on a routine basis.

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

The risk-return trade-off implications should be taken into account with reference to transactions or arrangements among parties at arm’s length. Among parties at arm’s length, transactions occur in part because such parties have different assessments and preferences for risk. It is difficult to imagine a coherent application of the arm’s length principle that did not take this into account.
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?

Yes, under the arm’s length principle the risk-return trade-off should apply to transactions or arrangements, such as asset transfers, that have an element of shifting risk from one party to the other.

Additional Comments on Section D.2 (paragraphs 41-78)

Section D.2 of the Discussion Draft describes business risks that may be faced by associated enterprises, and how risk may be allocated by contract and assumed in practice. The conclusion of D.2 is that risks should be allocated based on the actual conduct of associated enterprises rather than on contractual arrangements and that the only relevant conduct for this purpose is the control or management of risk. See in particular ¶¶ 60-72. This conclusion is not consistent with the arm’s length principle for several reasons.

First, as noted above, parties dealing at arm’s length routinely agree to assume risks over which they have limited control. Examples include an equity investor of a widely held company, an insurance company, and a principal dealing with a professional or financial advisory firm. All of the examples illustrate one party assuming and bearing risk that is actually controlled or managed by another party.

Second, at arm’s length, one party may contract with another party to manage risk. Indeed, the senior management and governing bodies of MNEs can be viewed as having been hired to manage the risks born by the investors in the MNE. While it is possible that such senior management may be compensated in part based on the outcome of such risk assumption, it is also possible that they may be compensated on a completely different basis.

The example in ¶ 63 illustrates this point. In the example, one company owns specialist equipment that is used by another group company. The company that owns the equipment does not have the capacity to use the equipment directly. The example concludes that because the
owner does not have the capacity to use the equipment directly, it cannot be entitled to the returns from the equipment beyond a mere financing return. This conclusion is incorrect so long as there are other potential users of the equipment in the market that would be willing to agree to the owner’s preferred allocation of commercial risks related to the equipment. At arm’s length, the owner of the asset is in the position to negotiate with potential users for the most favorable terms given its risk preferences. If the owner wished to assume the commercial risks related to being the owner of the equipment, it would undoubtedly be able to secure an arrangement with a capable user of the property pursuant to which that user would retain the returns associated with its functions and the owner would obtain the returns from the use of the equipment.

Other examples exist as well. The assertions in ¶ 64 – that a cash investor in a business generally will ask for appropriate security or guarantee to cover risk – are incorrect as applied to an equity investor. An equity investor is willing to make cash investments in exchange for a share of the returns of the business, often with little or no ability to control or manage the risks of that business. In addition, ¶ 65 could be read to state that it is not possible for an investor to hire another person to evaluate and manage risks without providing that person the returns associated with that risk. We believe this notion is incorrect and inconsistent with observable behavior by parties at arm’s length. As a final example, ¶ 70-72 could be read to state that actual transactions undertaken by associated enterprises should be disregarded or ignored to the extent they result in risk allocation to a party that is not better placed to manage that risk. This assertion raises significant issues and concerns, and is not consistent with observable behavior by parties at arm’s length.

D.3 Interpretation

The NFTC supports the clarifications set out in ¶¶ 81-82. While we urge the OECD to avoid language that conveys skepticism for written agreements (see ¶ 80), we appreciate the observation in ¶ 81 that “[e]very effort should be made to determine pricing for the actual transaction as accurately delineated under the arm’s length principle.” The language in ¶ 82 is also helpful in that it reaffirms fundamental elements of the arm’s length principle: “Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm’s length arrangement.” We also welcome the clarification in ¶ 82 that non-recognition of arrangements is appropriate only in exceptional circumstances: “[u]nless the strict criteria for non-recognition set out in [section D.4] are met, the conclusion should be that the transaction as accurately delineated is recognized.” ¶ 82.

But though welcome as guiding principles, these limitations seem to be lost in the examples throughout the Discussion Draft, specifically, those examples that ignore the written agreements between associated enterprises. The process prescribed for accurately delineating
transactions ignores the terms of written agreements. The revised guidelines should make it clear that every effort should be made to determine the pricing for the actual transaction arranged by associated enterprises without second guessing the terms of agreements through the “accurate delineation” process.

D.4 Non-recognition

While the Discussion Draft recognizes that non-recognition “can be contentious and a source of double-taxation,” the draft does not go far enough to establish non-recognition as a tool that should be reserved only for exceptional circumstances. ¶ 84. The draft rightly points out that, compared to independent parties, related parties have the ability to enter into a much greater variety of arrangements, and the mere fact that a transaction is not or rarely seen between unrelated parties is not a reason for non-recognition. But, as with the Discussion Draft on the whole, the section on non-recognition is problematic to the extent that it departs from the arm’s length principle.

It is not clear why the current standard in the Transfer Pricing Guidelines – which requires tax authorities to demonstrate that the arrangement differs from those adopted by parties at arm’s length and such differences impede the determination of an accurate transfer price – is being abandoned in favor of a test that looks to whether the arrangement has the “fundamental economic attributes” of arrangements between unrelated parties. See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“Transfer Pricing Guidelines”), Ch. I, D.2, ¶¶ 1.64-1.69. If an arrangement can be fairly priced, there should be no issue under the arm’s length principle. This is the case even if such an arrangement may not be observed as between parties at arm’s length or even if tax authorities in their judgment believe that parties at arm’s length would not have undertaken such a transaction. At a minimum, the OECD should clarify the rationale for substituting what appears to be a new test or inquiry for the current guidelines.

The “fundamental economic attributes” standard adopted by the Discussion Draft appears to be based on the extent to which a transaction or arrangement would enhance or protect the commercial or financial position of each of the associated enterprises entering into the transaction. The Discussion Draft states that “[a]n arrangement exhibiting the fundamental economic attributes of arrangement 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 . . . . 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 recognized for transfer pricing purposes.” ¶ 89.

The NFTC is concerned about the workability of the “fundamental economic attributes” standard. For one thing, it is difficult to evaluate the application of this standard to common
transactions, in particular in the business restructurings context. For example, how would the standard be applied where an MNE decides to close or reduce the output of a production facility? Such a decision would not enhance or protect the commercial or financial position of the associated enterprise running the facility. Is that a transaction that should be evaluated under the fundamental economic attributes standard? Should the transaction be disregarded unless that associated enterprise is compensated for the loss in its commercial or financial position, even if it has no property rights with respect to future production?

As another example, how should the standard be applied where an MNE decides to provide management from a central location (e.g., the location of the parent company) instead of locally, and charges the associated operating companies an arm’s length fee for such management services based on a cost-plus allocation? From the perspective of an associated enterprise operating in a low cost jurisdiction, such an arrangement may not enhance its commercial or financial position because it potentially could have hired local management for reduced fees. In this example, would the MNE be required to establish and quantify the enhancement to the commercial position of each associated enterprise to meet the “fundamental economic attributes” standard?

We note that parties at arm’s length often engage in transactions that do not enhance or protect their financial position. This may be the case as a result of changes in economic circumstances or a lack of negotiating leverage. Facilities may be closed, and ventures abandoned. Under the “fundamental economic attributes” standard, the entities in an MNE would be held to a different and higher standard. In effect, the Discussion Draft would compel an MNE to use its power to control its constituent entities to protect them from economic harm or a disadvantageous transaction. An underperforming facility would be kept in operation so that its owner would not engage in a transaction that did not enhance or protect its economic position.

The issues raised by the “fundamental economic attributes” standard are illustrated in the example in ¶¶ 90-91. In this example, S1 sells a trademark used in its business to an associated enterprise, S2, for $400 million. S2 licenses the trademark to S1 for use in its business, and S1 provides marketing and other services to S2. S2 has employees with the capacity to assess, monitor, and direct the use of the trademark, but no capacity to directly exploit the trademark. The MNE intends that the additional costs of the S2 operation will be offset by the tax savings attributable to the royalty deduction claimed by S1. Paragraph 92 concludes that the arrangement lacks the fundamental economic attributes of arrangements between unrelated parties because the arrangement does not enhance the commercial or financial position of S1 or S2. In particular, the arrangement does not enhance the commercial position of S1 because it has transferred an asset that is important to its businesses and is therefore reliant on another person (S2) for the ongoing viability of its business.
It is impossible to reconcile the results of this example with the arm’s length principle for several reasons. First, the result appears to depend on S1’s ownership of the trademark at the outset. Would the result be the same if S2 had developed and owned the trademark initially? Would the “fundamental economic attributes” standard require that S1 be considered the owner of the trademark from the outset, or that S2 transfer the trademark to S1 at some point? The result seems inconsistent with the guidance in the business restructurings chapter. See Transfer Pricing Guidelines, Ch. IX, Part III, A.1, ¶ 9.123.

Second, the example leads to the untenable conclusion that the owner of an asset is not allowed to transfer such asset (by sale or license) to a related party. This is absurd. Parties at arm’s length transfer assets that they own all the time; the right to do so is one of the benefits of ownership. To the extent this is considered appropriate from a policy perspective, it should be effected through a change in law (either domestic legislation or tax treaties) rather than through interpretation of the arm’s length principle.

Finally, the import of S2’s organization in a low-tax location, and the tax motivation of the MNE, is not clear. Would the result of this example be different if S2 were located in a jurisdiction with tax rates comparable to that of S1? Would the result of this example be different if the MNE could demonstrate pre-tax cost savings from centralizing its trademark management in a single entity, even though such cost savings would not affect the commercial or financial position of S1? These factors seem better assessed under substantive tax rules or anti-abuse rules rather than as an interpretation of the arm’s length standard.

For these reasons, we strongly recommend that the example in ¶¶ 90-91 be reconsidered or removed.

**Special Measures**

The NFTC has serious reservations regarding the proposed special measures. The stated purpose of the special measures, as with BEPS Action Items 8, 9, and 10 generally, is to ensure that transfer pricing outcomes are in line with value creation and to limit BEPS risks for governments. See ¶ 6. The extent to which the proposed special measures accomplish this is not clear, and the overall impact of the special measures is not possible to assess without more detailed descriptions of the special measures themselves. As special measures should only apply in narrow cases where transfer pricing outcomes clearly are not in line with value creation, the development and discussion of specific special measures should not proceed until the BEPS project has been implemented and the efficacy of changes to the Transfer Pricing Guidelines and other BEPS outcomes has been assessed. The special measures on the whole become relevant only when BEPS initiatives have been tested and found to be insufficient.
Assuming a demonstrated need for special measures, special measures may be an appropriate response to specific situations involving a high risk of BEPS and are preferable to changes in the Transfer Pricing Guidelines that depart from the arm’s length principle. However, the concept of special measures is, in general, problematic for various reasons. For one thing, the availability of special measures permits tax authorities to reallocate profits that have been appropriately allocated under the arm’s length principle. This ability could incentivize tax authorities to claim a greater share of profits than warranted by the circumstances. Jurisdictions in which profits are appropriate allocated under the arm’s length standard would presumably be reluctant to give up tax revenue, and so the taxpayer in this scenario would be faced with double taxation and no agreed framework for resolution. More generally, adding a set of special measures to the options already available to tax authorities will eliminate the certainty provided by broad acceptance of the arm’s length principle and undoubtedly increase transfer pricing disputes.

Notwithstanding our general reservations regarding special measures, we provide below some preliminary comments with respect to the specific special measures identified by the Discussion Draft.

**Option 1: Hard-to-value intangibles (“HTVI”)**

In general, a post-hoc approach to valuing intangibles is problematic because it undermines certainty for MNEs engaging in cross-border trade and investment. Accordingly, to the extent this special measure is considered, the circumstances in which it may be applied should be very narrow. As currently articulated, the special measure could apply to virtually any transfer of intangibles because reliable comparable transactions may not exist and because the assumptions used in conventional valuation methods could be considered speculative. Valuations based on sound economic principles and conventional methods should be accepted absent significant risk of BEPS. In cases where there is significant risk of BEPS, post-hoc analyses could be considered in the exceptional circumstances where (1) the actual results turned out to be materially different than the estimated results, and (2) the difference is due to events that could have been foreseen but were not taken into account in the valuation, rather than reflecting the outcome of risks that were not possible to foresee at the time of the agreement.

**Inappropriate returns for providing capital: Option 2 and Option 3**

These special measures are dramatically out of step with the arm’s length principle and current international norms. Among other shortcomings, it would substitute the judgment of tax authorities for capital allocation decisions and business judgments of MNEs. The NFTC strongly opposes these measures.
Option 4: Minimal functional entity

This special measure can be considered an application of Option 2 to “minimal function entities.” It does not seem appropriate to reallocate returns away from such entities where such returns have been allocated to them under revised Transfer Pricing Guidelines. Even assuming this was appropriate from a policy perspective in some cases, there is no principled way to set quantitative criteria for whether entities are minimal function entities, and qualitative criteria would be difficult to consistently apply. The NFTC strongly opposes this measure.

Option 5: Ensuring appropriate taxation of excess returns

The NFTC opposes this special measure as it reflects a significant departure from the arm’s length principle and moves in the direction of a formulary rule. While the primary rule may be an appropriate means to give the parent company’s jurisdiction taxation rights over excess returns (if the jurisdiction’s legislation so provides), measures of this type are better considered as part of the consideration of appropriate CFC legislation. The NFTC strongly opposes the secondary rule as it seems to contemplate the formulary apportionment of profits to other jurisdictions on a basis other than the arm’s length principle.

Sincerely,

Catherine G. Schultz
Vice President for Tax Policy
National Foreign Trade Council
cschultz@nftc.org
202-887-0278 ext. 2023
Appendix to NFTC Comments on BEPS Action Items 8, 9 and 10: Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)

NFTC Board Member Companies:

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February 6, 2015

VIA E-MAIL (TRANSFERPRICING@OECD.ORG)

Mr. Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
Organization for Economic Co-operation and Development  
2, rue Andre Pascal  
75775 Paris Cedex 16

Dear Mr. Hickman:

I am writing on behalf of Noble Corporation plc ("Noble") in response to the request for public comment to BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (the "Discussion Draft") and specifically the potential "special measures" proposed therein. Once the details are made available, we plan to register for the public consultation to be held on March 19-20, 2015. We would appreciate the opportunity to share our views by speaking or participating at the public consultation.

Noble owns and operates worldwide one of the most modern, versatile and technically advanced fleets in the offshore drilling industry. This fleet of ocean-going, ultra-deepwater and jackup drilling rigs can operate in water depths up to 12,000 feet and drill wells to depths as great as 40,000 feet. These rigs are mobile and are deployed around the world, at locations off the coast of Europe, the Middle East, Africa, Asia and Oceania, and North and South America, and they are moved to the locations where Noble’s customers need them to explore and drill for the crude oil and natural gas that fuels the world economy.

Noble’s concern with the special measures is that their breadth far exceeds the scope of recommending international guidelines for transfer pricing regulation, and are not an appropriate means of allocating the profits of an offshore drilling company. These special measures invite governments to write arbitrary rules that are in no way tied to the BEPS goal of aligning profits with value creation, and to use these rules to assess taxes whenever the underlying, time-tested transfer pricing rules don’t meet their revenue needs. Moreover, the proposals seek to regulate the structure of Noble’s business. Thus, they deny Noble the ability and right to organize and deploy its assets and labor force worldwide in the form and jurisdictions that are most economically beneficial, and best help Noble to serve its customers by efficiently searching for oil and gas. This is harmful to global commerce and productivity, because these worldwide activities generate tax revenue for OECD member states, and for other nations, and because inefficient taxation depresses economic activity.
Further, the special measures are overly broad in that they seek to apply standards that treat all industries the same. As noted in question 9 of the framework for questions on all options, it is appropriate to consider whether certain sectors should be excluded from the application of the measures. Noble’s offshore drilling business is a capital intensive enterprise in which profits are derived almost entirely from drilling rigs that are mobile and international in scope. Thus, Noble’s business has little in common with high-technology industries in which value is derived from developing and exploiting intangible property, which industries are the main focus of the Discussion Draft and the overall BEPS effort. One-size fits all standards such as these can rarely fit such disparate enterprises, and for the reasons explained below, offshore oil and gas drilling should be excluded from an exercise in addressing industries based on intangible property.

Background and Overview of the Offshore Drilling Business

Overview of the Offshore Drilling Business

As indicated above, Noble’s business is a capital intensive enterprise that consists of providing contract drilling services to customers that are engaged in the exploration for, and production of, oil and gas in offshore areas around the world. The demand for Noble’s offshore drilling services is driven primarily by (a) the technical specifications and capabilities of its drilling rigs, (b) the locations around the world where customers can produce oil and gas most profitably (which locations change depending on global oil and gas prices and the cost to produce, and the quality of, the oil and gas that can be extracted at a particular location), and (c) the price at which Noble offers the drilling services. In this regard, some regions are in decline and others are experiencing a surge in drilling activity; some regions produce types of crude in high demand, while others produce out-of-favor grades because of excess supply or refinery mismatching; some regions produce only natural gas.

In response to constantly changing customer demands and specific contract opportunities, Noble must frequently move its drilling rigs to different locations. In most countries, a company that performs offshore drilling services must be incorporated or otherwise established under the laws of the country in which the drilling occurs. Thus, offshore drilling companies are typically required to form a new subsidiary each time a drilling rig moves to a new location. However, it would potentially be very costly (in terms of administrative delays and capital gains taxes) to transfer ownership of the drilling rig to each such new subsidiary.

In order to facilitate the movement of its drilling rigs between jurisdictions while avoiding the costs of repeatedly transferring ownership of the rigs between subsidiaries, Noble’s business is structured such that the subsidiary that owns the drilling rig (the “Rig Owner”) is typically a separate entity from the subsidiary that performs drilling services for the customer under a drilling contract (the “Rig Operator”). The Rig Owner makes the drilling rig available to the Rig Operator under a bareboat charter or dry lease (“BBC”). Under this structure, the Rig Owner remains the same while the identity of the Rig Operator changes (and a new BBC is put in place) when the rig moves to a new jurisdiction. This business model is not unlike the
business models adopted in other industries (such as the airline and shipping industries) that employ large mobile capital assets to provide services to customers.

Rig Owner Functions and Risks

The drilling rig, which costs hundreds of millions of dollars to construct, is the asset responsible for creating almost all of the value in the drilling industry. The Rig Owner must acquire or oversee and fund construction of a drilling rig and thereafter is responsible for maintenance, modifications and preparation for use, deployment, inter-company leasing, and disposition of the rig. The Rig Owner carries out these functions through a small staff that is located in the Rig Owner’s jurisdiction of organization and is highly experienced in the offshore drilling business.

Under the drilling contract, the third-party customer typically pays a dayrate to the Rig Operator, which pays a portion of such dayrate to the Rig Owner under the BBC. The drilling contract dayrate (and, accordingly, the BBC rate) is typically reduced during down time, which may occur during time of repair or inclement weather. The Rig Owner receives no income under the BBC unless the Rig Operator has residual revenues from the drilling contract with the customer.

In addition to performing the functions described above, the Rig Owner assumes most of the economic risk of the enterprise. The Rig Owner alone bears the economic risk that (a) a rig will be idle (i.e., not under contract with a third-party customer) because the rig will not be generating rental income under the BBC during such period, (b) the rig will have down time during the third-party drilling contract resulting in lower or no dayrates and lower or no BBC payments, and (c) a rig will become obsolete within the drilling industry. Moreover, the Rig Owner alone bears the opportunity costs with respect to the invested capital during the period in which a rig is under contract with a customer. As a result, a Rig Owner is the primary entrepreneur in the offshore drilling business.

Rig Operator Functions and Risk

The Rig Operator is responsible (but often relies on affiliates) for contract negotiations with third-party customers, collecting dayrates, and supplying the rig with repair parts and operating supplies. As indicated above, although the Rig Operator is responsible for entering into third party contracts, such contracts are heavily dependent on the specifications of the drilling rig owned by the Rig Owner (and provided to the Rig Operator under a BBC). The Rig Operator also recruits and further trains skilled personnel to operate the rig, and thus drill oil and gas wells at the direction of its customer, and ensures compliance with environmental, health and safety regulations. The Rig Operator acts as a coordinator for the various services provided to the third-party customer along with the rig. The Rig Operator manages regulatory, personnel, reputational, and downtime/capacity risk due to operational issues. Because major liability and casualty risks are passed on to the Rig Operator under the BBC, the Rig Operator maintains insurance for these risks.
The Rig Operator typically operates a shore-based office in the jurisdiction where the rig is operating offshore. As a labor-based business, the assets owned by the Rig Operator are usually minimal, and the Rig Operator does not have significant levels of capital employed relative to the Rig Owner (see chart below). Instead, its revenue is dependent on the duration of the drilling contract. The crew is expert at their very difficult jobs of drilling for oil and gas in deep water under harsh conditions, but their expertise is standard across the drilling industry and their contribution to the business enterprise is providing a service to the customer rather than developing valuable intangible assets.

The following chart provides an example of the typical levels of capital that are deployed by the Rig Owner (dark blue) and the Rig Operator (yellow):

### Relevant OECD Special Measures

The Discussion Draft states that the “main aim of the Transfer Pricing Actions is to assure that transfer pricing outcomes are in line with value creation,” and it continues by stating that one of the main aims of the special measures is “to limit BEPS risks for governments.” The BEPS Action Plan also indicates that “special measures, either within or beyond the arm’s length principle, may be required with regard to intangible assets, risk and over-capitalisation” in order to achieve this aim. In proposing various options to address transfer pricing issues, the special measures include the following options relevant to Noble’s business structure and its deepwater offshore drilling activity:
Option 2 — Independent investor

Under this option, in order to supposedly ensure a closer alignment between transfer pricing outcomes and value creation, and applicable to circumstances where the capital rich, asset-owning company depends on another group company to generate a return from the asset, the capital of the asset-owning company would be deemed to be contributed to the company that provides the more rational investment opportunity (i.e., the company with the expertise to generate the profit). The basis for this standard is questionable, in that not all investors are created equal and can both afford to pay for, and are willing to assume the risk of, the highest return. Some wealthy investors choose low risk investments in protection of their capital; others seek yield and hope for the best. Investors also follow their own expertise; some may understand capital intensive industry, while others are experienced in service businesses that maintain a labor force.

Moreover, this enterprise-level expertise based, follow-the-highest-return approach fails to take into account the fundamental nature of the assets and business enterprise in question. In Noble’s case, the value is derived almost entirely from the tremendous investment and risk undertaken by the Rig Owner to build and deploy a deepwater drilling rig. Without the drilling rig, which costs hundreds of millions of dollars to acquire or construct, no oil or gas can be drilled for or discovered. Much like a hotel real estate ownership business working in tandem with a hotel operating company, the tangible asset drives the value; without a hotel, no guests are going to spend the night and pay upon checkout, no matter how fine a staff has been assembled. In both cases, the service workers perform labor that is a small percentage of the value of the transaction. Thus, in the case of the offshore drilling business, this expertise-based standard fails to narrowly target and measure a closer alignment between transfer pricing outcomes and value creation, most likely because this standard was developed with intangible assets and industries in mind where more value flows from scientific expertise rather than exploiting tangible assets. In addition to hotel companies that split ownership of real estate from management services, other similar industry examples include aircraft leasing and equipment leasing that split ownership from operations, and demonstrate the arm’s length nature and value equation of a bareboat charter, be it a ship, plane or crane.

At least insofar as offshore drilling companies such as Noble are concerned, Option 2 provides a remedy that should already be reflected in the arm’s length standard, and is therefore unnecessary, and does not ensure a closer alignment between value creation and transfer pricing outcomes. Thus, Option 2 should not be permitted to override existing transfer pricing rules. See comments by Kenneth Wood, Senior Manager in the IRS’s Advance Pricing and Mutual Agreement Program, 23 BNA Transfer Pricing Report 502 (Aug. 7, 2014) published at link.

Option 3 — Thick capitalisation

This option is applicable to circumstances where the asset owning company is said to have excess capital (i.e., insufficient leverage), based on comparing the group leverage to the branch leverage ratio. If the leverage is found to be insufficient under the pre-determined ratio,
thus generating insufficient interest payments to attribute back into the income of the capital-supplying affiliate, additional interest payments would be attributed. Without providing much guidance on how it would determine an appropriate capitalisation ratio, this special measure of reattribution rewrites the basic capital structure and risk tolerance for leverage of the parties.

It also may seek to override treaty benefits that have been negotiated in good faith between two countries. A tax rate based on the give-and-take of a mutually beneficial tax treaty should not be assumed to patently be a “low tax jurisdiction” tax rate. It is not BEPS either, in that the base hasn’t eroded, or the profit shifted; instead the governments of the treaty party countries have agreed not to tax the international operations of each other’s citizens and businesses.

While this option seeks to measure closer alignment between value creation and transfer pricing outcomes, it would also subject offshore drilling companies to burdensome compliance and reporting requirements. As discussed above, a company’s drilling operations in a particular year depend on the risks and rewards of deepwater drilling and the assets being used in a location for that period, all of which are subject to change with frequency. Rewriting a company’s capital structure each year to suit international tax standards would be complex and arbitrary; it could lead to widely different results in different jurisdictions and for different taxpayers.

Option 4 — Minimal functional entity

This option is applicable to circumstances where the asset owning company has “minimal functions” and lacks “fundamental economic attributes that normally underpin arrangements between unrelated parties.” In such case, the profits of the asset owning company would be reallocated to the entities performing the key functions or to the parent of the asset owning company. Implied in this option is that business enterprises with global reach and large balance sheets are by their size in need of large staffs where they are doing business. Option 4 is designed to target industries (such as technology and pharmaceutical companies) that maintain “cash box” subsidiaries that own valuable IP assets but perform no functions to develop or exploit such assets. See comments by Pascal Saint-Amans (Head of OECD Center for Tax Policy and Administration) quoted by BNA at link.

While Option 4 may be well-suited to IP-owning companies that derive value from developing and exploiting intangible property, it is clearly not well-suited to offshore drilling companies that derive value almost entirely from capital investment in drilling rigs. As detailed above, the Rig Owners maintain staffs that perform critical functions to run the enterprise. As a result, the Rig Owner is the primary entrepreneur in the business. Thus, in no way does the Rig Owner “lack the functional capacity to create value through exploiting its assets and managing its risks . . . ."
Option 5 — Ensuring appropriate taxation of excess returns

This option is applicable to circumstances where a controlled foreign subsidiary earns profits in a low-tax jurisdiction. In such case, because “the BEPS project is fundamentally motivated by the shifting of income intra-group to locations where it is taxed at a low rate or not taxed at all,” excess returns will be taxed in the parent jurisdiction or allocated to other appropriate jurisdictions.

Option 5 is a clear deviation from the stated aim of the Transfer Pricing Actions (i.e., that transfer pricing outcomes are in line with value creation) and represents a special measure to prevent competition among jurisdictions with respect to tax rates. It does nothing to advance the aim of assuring that transfer pricing outcomes are in line with value creation, and confirms that the real goal is as stated on p. 39 of the Discussion Draft, “to limit BEPS risks to governments.” In effect, Option 5 acts as a safety, trying to sweep in revenue where the substantive principles of the earlier options have failed to collect more tax for OECD countries by assigning a minimum level of tax worldwide, even in jurisdictions that, in an exercise of their sovereignty, choose to impose low tax rates. Such a method takes the principle of one-size fits all taxation rules one step further into one-size fits all taxation rates, for all countries, regardless of their circumstances, and ignores the fact that in an international business such as Noble’s, much of the value creation activity occurs in far-away land and seas.

Options 4 and 5 inherently lack (and are incapable of having) objective standards under which they could be applied and therefore result in arbitrary reallocations of income. Such remedy represents nothing more than an exercise of taxing power to achieve a pre-ordained result. Moreover, such remedy will not have the effect of aligning transfer pricing outcomes and value creation, particularly within the offshore drilling industry where capital creates almost all of the value. See comments by Kenneth Wood, Senior Manager in the IRS’s Advance Pricing and Mutual Agreement Program, BNA Transfer Pricing Report (Jan. 13, 2015), published at link.

Conclusion

There is no economic rationale, or prior taxation rationale, or prior situs rationale, as to why the economic structure of an offshore drilling business can be dictated, or the profits of such business taxed, in a distant high tax OECD jurisdiction for a deepwater drilling rig that was designed in South Korea, constructed in China, deployed in the Middle East, moved to Brazil, cold-stacked or stored during a period of high supply and low demand because of low crude oil prices, and then moved and deployed again repeatedly as the market warrants. These capital intensive assets are transient by their nature, require a small labor force, and create value by exploring for oil or gas under difficult conditions. Instead, the special measure proposals seek to regulate the economics and structure of Noble’s businesses, and thus deny Noble the ability and right to organize and deploy its assets and labor force in the form and jurisdictions that are most economically beneficial. The special measures would allow governments to set aside the objective standards of their current transfer pricing rules, tax codes, and treaties, and authorize and encourage them, under the cloak of OECD authority, to seek ever greater shares of the value.
created in other jurisdictions using mechanisms that do not provide predictable results and lack transparency.

This action and precedent is harmful to global commerce and productivity, to the production of energy that powers the world economy, and thus to tax revenue worldwide. Heavy industries, such as offshore drilling, in which capital creates almost all of the value should be excluded from the special measures, and transfer pricing activity should be re-focused on using more comparable transactions in the specific industries and countries where economic activity is taking place, rather than seeking to regulate economic outcomes for the purpose of reallocating revenue from company to company and country to country.

Sincerely,

Barbra Beaulieu
February 6, 2015

BEPS Action 8, 9 and 10: Discussion draft on revisions to Chapter 1 of the Transfer Pricing Guidelines

Comments by Pat Breslin of NERA Economic Consulting

Dear Mr. Hickman,

I would like to thank you and the members of the relevant OECD committees and working parties for the opportunity to comment on the above-mentioned document.

First, I should draw your attention to a set of comments prepared by my colleagues at NERA, Pim Fris, Emmanuel Llinares and Vladimir Starkov, which have also been submitted in response to this request for comments. Their comments address a number of areas of interest to the OECD’s ongoing work on issues related to risk and value creation.

My comments are encapsulated in the attached article entitled “Coin Flips, Rational Decisions and Risk: Support for OECD Draft Guidance on Chapter 1,” soon to be published in Tax Management Transfer Pricing Report. In it, I attempt to bring an additional perspective to bear on the interrelationship between risk and value creation. While the article focuses on risk issues related to “hard-to-value” intangibles, it addresses risk and value creation more broadly and across the entire value chains of many industries.

In particular, the article draws attention to the way in which risk and value creation interact within sequences of actions and events. The range of potential outcomes from each step taken, or each risk assumed, is never one-sided or unidirectional. To assume risk is to recognize that there are two sides to this coin, with potential outcomes that are both favorable and unfavorable. With that, I will allow the attached article to elaborate on my views, as summarized in its introduction.

Sincerely,

Patrick Breslin
Washington, DC
February 2015

1 These comments represent the independent views of the author and do not necessarily reflect the views of NERA Economic Consulting, or any of the author’s colleagues. The author would like to thank Vladimir Starkov of NERA in Chicago for his helpful review and comments.
Coin Flips, Rational Decisions and Risk: Support for OECD Draft Guidance on Chapter 1

The author uses a game model involving four coin flips to show how the payoff for participants taking risk increases with the certainty of favorable outcomes. The model offers support for a recent OECD discussion draft on identifying risk in commercial transactions by highlighting how the rational decisions made in arm’s-length transactions involving investments in hard-to-value intangibles contrast with decisions sometimes made by related parties in comparable circumstances.

BY PATRICK BRESLIN, NERA ECONOMIC CONSULTING

In its recent discussion draft on risk and recharacterization,1 the Organization for Economic Cooperation and Development has added substantial new guidance on identifying risk in commercial and financial relations. The draft, which would revise Chapter 1 of the OECD transfer pricing guidelines, brings needed clarity to an often-discussed but not well-understood aspect of transfer pricing: risk. Risk is not alone among important issues on the current OECD tax agenda, but perhaps no other single issue has greater impact on the alignment of transfer pricing outcomes with value creation—a stated core objective of the OECD’s Action Plan on Base Erosion and Profit Shifting (BEPS).

The arm’s-length principle articulated in the OECD guidelines has long invoked the need to analyze the parties to a transaction, including the functions they perform, the assets they employ and the risks they assume. But in practice, analysis of risk often takes a back seat to voluminous “functional analyses” that address who does what at a basic level. Less analysis has addressed when and where risks actually are assumed within the multinational enterprise, and what it really means to assume risk.

Previously, many have focused on the allocation of risk as provided in intercompany contracts and described in documentation reports. This coincides with the mistaken perception that “risk allocation” entails a high degree of flexibility—as if one can simply relocate the impact of—and control over—risk as desired in order to justify having related returns realized in preferred places.

In contrast, from the standpoint of the draft, the allocation of risk must recognize where risks in fact arise and are faced, who bears the real consequences and who has the ability to manage them. Indeed, the draft’s greatest contribution may be its clear explication of risk management, along with related examples. The draft observes that risk management is endemic to company operations; business managers inherently control risks every day. Whether they are professionals in research, manufacturing or sales, people making decisions are taking risks—win or lose.

Some standard risks that are assumed in large numbers by many parties can be shifted at arm’s length—for example, in the insurance industry. But rarely would one willingly accept another party’s risk without sufficient information and expertise to manage it. Even if businesses can outsource a subset of their risks to other

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1 Available at 23 Transfer Pricing Report 1170, 1/8/15.

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experts at risk management—for example, insurers—a company’s return attributes to the areas of its own expertise, special skills or capabilities. In this way, value creation is aligned with the risks the business must face in performing its mission.

This article will add support for specific sections of the revised Chapter 1, offering additional perspectives on the inherent connection between risk and value creation. To this purpose, it includes a game model to analyze how participants taking risk may realize payoffs that increase with the certainty of favorable outcomes. The game is compared to the rational decisions made in arm’s-length transactions involving investments in “hard-to-value intangibles.” These examples are contrasted with the decisions sometimes made by related parties involved in similar transactions under comparable circumstances. In such cases, parties taking early-stage risks forgo related returns, resulting in BEPS.

Finally, the article makes observations about the draft’s comprehensive discussion on risk management. Fundamental aspects of risk management are described in relation to key elements of certainty itself, which may include the passage of time or events, information, and experience or expertise. When these elements can be leveraged, risk—that is, uncertainty—is better managed.

**Value is created in a sequence of actions and events**

Naturally, the genesis of value creation for any product or service occurs in the early stages of its development. A typical value chain reflects a sequence of activities with a natural order, from research and development and product development to manufacturing, marketing, distribution, sales and after-sales services. Some activities, such as R&D, weigh more heavily in the early development stages, while others, such as manufacturing and sales, begin at later stages and continue well after products are fully developed.

Embedded within these high-level activities there may be other underlying sequences. For example, the revised draft Chapter 6 refers to the ownership and management of intangibles as involving their “development, enhancement, maintenance, protection and exploitation.” This sequence may be seen as something of a microcosm residing both within and in parallel with the overall value chain. That is, some of these activities may be considered a subgroup of “upstream” R&D, such as “development” of technology intangibles, while “exploitation” relates to “downstream” marketing and sales of related products, for example.

The steps in these sequences may not necessarily occur in perfect linear order. Some products or services (such as software and e-commerce sites) may undergo continuous development, enhancement and maintenance, with paying customers expecting and consistently receiving updates. In other cases, the R&D process consists of a portfolio of many projects at different stages of development, while existing products flow downstream through the full value chain.

Still, there remains a natural order. One cannot exploit, enhance or maintain an intangible before its initial development. Such steps cannot yet be meaningfully taken, or not enough is yet known to warrant them, much less to incur the related costs. Investments in product manufacturing, marketing and distribution activities—or full use of the capacity for those activities—generally occur later, and only if the relevant R&D itself is successful.

In fact, at the early stages of development, little is known about the prospects of the project overall. Thus, early-stage investments in R&D are among the most uncertain, or risky. Subsequent development and investments (in manufacturing and sales) depend on the success of early-stage R&D investments, without which there would be no new product to justify them.

Another defining stage of development is the commercialization of the product or service. This is the turning point at which independent customers validate the value proposition—that is, they pay for it. This major milestone justifies expansion and later-stage investments that can be made with far less uncertainty relative to when the earlier investments were made and their outcomes were unknown. Paragraph 6.121, after “Stage of development,” aptly states, “As a general rule, intangibles relating to products with established commercial viability will be more valuable than otherwise comparable intangibles relating to products whose commercial viability is yet to be established.” (Emphasis added.)

This link between the riskiness of a project and its return (or value) is often cited, but not always well-understood. Clearly, value-creating activities and risk are inextricably linked with sequences of actions and events. The uncertainty that relates to them can be resolved only with the unfolding of these events or the passage of time.

Of course, other factors also account for and contribute to value creation—sometimes in a more direct way—as is well-described throughout the revised guidelines. But in the early stages of a development process—one that depends on a series of successful outcomes—the uncertainty attached to each outcome has a “make or break” quality. R&D and other high-risk endeavors may succeed, or they may fail. When this compressed sequence of uncertainty is resolved, risk subsides and value is created (or not). Full stop.

**Game 1: Risk through four coin flips**

To illustrate this high-stakes development process, consider a game wherein a player is able to pay $5 for a ticket that could win $100 depending on the outcome of four flips of a coin. If the coin flips produce “heads” four consecutive times, the player wins $100. If “tails” results from any one of the four coin flips, the game ends and the player loses the value of the $5 ticket. In this game, the player has a 6.25 percent chance of winning $100 for a total gain of $95, and a 93.75 percent chance of losing $5. This probability is based on a simple expected value computation that considers the 50 percent probability of “heads” resulting in each of the four consecutive coin flips \(0.5 \times 0.5 \times 0.5 \times 0.5 = 0.0625\), or 6.25 percent. Thus, the $5 ticket actually is worth $6.25 (that is, $100 \times 0.0625) before the first flip.

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2 See draft, note 1 above, at para. 67.
of the coin, and it would produce an expected return of 25 percent \((\$6.25 - \$5) / \$5\).

The player might assess his tolerance for this level of risk and weigh this value against his alternatives for spending, saving or investing the \$5—in other words, his opportunity costs. Assume that in the game above (Game 1) the player cannot limit his risk by selling the ticket to another prospective player during the game. The holder of the \$5 dollar ticket is “all in” for the full sequence of four coin flips; that is, the ticket is non-transferable.

**Game 2: Risk transferable**

Now, imagine a variation on this game wherein another player may buy the ticket of the first player (Player 1), thus buying into the game at later stages—that is, after the outcome of one or more coin flips is known. Of course, this second player (Player 2) will be willing to buy only a ticket that has produced known success (all “heads”) up to this stage—a ticket is worthless when “tails” occurs. Also assume that Player 2 has perfect information and knows the current status of the game at each stage—that is, he knows which coin flips already have transpired and their outcomes.

It is important to note that the value of a ticket evolves when the outcome of each stage is certain. Correspondingly, risk—uncertainty—is reduced after each stage. For example, if the first flip—Stage 1—is “heads,” Player 1 is now only three flips away from winning \$100. Thus, the probability that Player 1 holds a winning ticket increases from 6.25 percent to 12.5 percent \((0.5 \times 0.5 \times 0.5 = 0.125, or 12.5\%\). The expected value of the ticket now is \$12.50 \((0.125 \times \$100)\) and the expected return to Player 1 at Stage 2 of the game is 150 percent \((\$12.50 - \$5) / \$5\).

In Game 2, before the second flip, Player 2 may be willing to pay \$12.50, more, or less for Player 1’s ticket, depending on his risk profile and opportunity costs. Player 1, on the other hand, should be willing to accept no less than \$12.50—assuming his appetite for risk remains unchanged during the game. Given the probability of three consecutive “heads” (12.5 percent) and the winning ticket value (\$100), a reasonable reference value for the ticket after a “heads” on the first flip is \$12.50, though players might negotiate different prices.

Correspondingly, the reference value of a ticket when all prior flips produce “heads” (hereinafter an “in the money” ticket) increases to \$25 after the second flip and to \$50 after the third flip, using the same expected value computations noted above.4 If Player 1 were to sell his ticket for these prices at these later stages, his return on the \$5 price of the ticket would be 400 percent and 900 percent, respectively.5

These higher returns reflect the risks assumed by Player 1, who purchased the original ticket before the game started and any outcomes were known. Naturally, a player demands higher returns whenever taking risks in the early stages of the game, when outcomes are unknown and probabilities of success are lower.

As discussed further below, this relationship between risk and return (or price) is observable in market data concerning risky investments in intangibles and transactions between independent parties, including early-stage investors in R&D-intensive companies and projects, as well as independent companies (often multinational companies themselves) that acquire such assets.

**Acquiring valuable technology at arm’s length**

As discussed in a previous article,6 venture capital (VC) industry data provide arm’s-length evidence of actual returns on high-risk R&D investing, as represented in the returns to investors in startups and other independent R&D-focused companies. Returns on VC investments are realized upon “exit,” which may occur through either merger and acquisition or an initial public offering (IPO).

Thus, the main mission for VCs and their funded companies is to develop ground-breaking technology and either sell it to established technology companies or get into the business themselves. VCs are a primary source of risk capital that is responsible not only for developing new technologies, but also for the existence of many major technology companies—including Amazon, Google and Intel.

This well-established and successful model of technology finance depends on the fact that established companies seek significant competitive advantages through the ownership of valuable technology assets and other intangibles—and they are not always able to develop it themselves, at least not before others obtain competing technologies. While licensing another’s technology is often an option as well, a higher level of control resides with the owner of a technology—yielding a wider range of options and advantages such as, for example:

- the right to further develop and own both the existing and related future intangibles,
- the right to preclude others (competitors) from developing or using such technology, and
- the right to license certain uses to others (or not; see item 2 above) and obtain royalty income.

Usually, independent companies (including multinational groups) own valuable technology assets as a result of one or both of the following approaches:

- they develop new technology internally through internal investments in R&D, or
- they acquire technology, often by acquiring independent, R&D-intensive startup companies that have successfully developed it.

The second approach is referred to as “external R&D” because these acquisitions generally serve the same purpose as investing in self-developed technology, or “internal R&D.” However, acquisitions of VC-funded companies usually comprise technology that has already met key milestones in its development (patented, tested, registered, successfully commercialized),

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4 That is, \$100 multiplied by: a) the 25 percent probability of two additional consecutive “heads” resulting after Stage 2 \((0.5 \times 0.5)\), and b) the 50 percent probability of “heads” resulting on the fourth and final flip after Stage 3, respectively.

5 That is, \((\$25 - \$5) / \$5 = 400\%\) and \((\$50 - \$5) / \$5 = 900\%\), respectively.

6 A more detailed discussion on aspects of this section can be found in a prior article by this author, “An Early-Stage Investor Analogy: How Related-Party Transfers of Intangibles Contribute to Base Erosion and Profit Shifting,” 22 Transfer Pricing Report 699, 9/19/13, where more detailed references also can be identified.
often along with the key personnel that achieved this success.

Thus, while these two alternatives reflect "options realistically available" as articulated in the revised draft Chapter 1,7 they carry with them different risks that reflect their relative value to the acquirer. As noted in paragraph 12, independent enterprises "will generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk or other comparability factors discussed below) when valuing those options."

External R&D is a lower-risk alternative than internal R&D because with acquired technology, key risks associated with the intangibles development up to the point of the acquisition are resolved. Correspondingly, the returns associated with these risks are realized by the sellers (the startup and its investors that assumed the risks), as reflected in the acquisition price (exit price) that the established company pays them.

This common arm's-length pattern is not unlike a potential scenario in Game 2 above, wherein Player 2 acquires Player 1’s ticket for $25 after Stage 2 when the coin flip game has produced “heads” two consecutive times—producing a return that is five times ($5 x 5) greater than the original $5 ticket price that Player 1 paid before the first of four coin flips. This return attributes entirely to the known outcomes; risk has been reduced and price increases accordingly. Of course, it was Player 1 who assumed the risks at the earliest stages of the game, not unlike the VCs and entrepreneurs in an acquired startup.

Similarly, the VC industry measures the success of individual investments based on a multiple of total value realized upon exit divided by the total investment in the startup company. VCs target exit multiples of 4 to 10x or greater on individual investments. Such high returns are necessary in order to offset unsuccessful investments in the portfolio while still rewarding VC investors with high returns commensurate with their risk.

For example, for the third quarter ended in September 2014, disclosed deal values of M&A transactions involving VC-funded companies had exit multiples as follows:8

- 25 percent of deal values exceeded 10x of total venture investment,
- 22 percent had multiples of between 4x and 10x,
- 28 percent of deals had values of 1x to 4x, and
- 25 percent did not recoup their full investments (had multiples of less than 1x).8

According to the press release:

The largest venture-backed M&A transaction in the period was Facebook’s $1.9 billion purchase of Oculus VR, an Irvine, Calif.-based developer of virtual reality headsets. Amazon.com Inc.’s $970 million acquisition of San Francisco-based Twitch Interactive ranked as the second largest venture-backed M&A deal during the quarter.10

Over the long term, investors in VC funds—portfolios of individual VC investments—are rewarded with substantially higher returns than equity investors in general. For example, for the 20-year and 15-year periods ended December 2013, VC fund returns (on full portfolios including unsuccessful investments) were 30.8 percent and 22.6 percent, respectively, while the Standard & Poor’s 500 returned 9.2 percent and 4.7 percent, respectively, over these same periods.11

Thus, at this economy-wide level, there is a clear contrast between returns to riskier earlier-stage companies focused on technology development and returns to companies with mature products and services that execute more evenly across the total value chain.

This pattern is even more pronounced within the universe of private VC-funded companies. That is, VC returns on early-stage investments far exceed returns they realize on later-stage investments. The U.S. venture capital fund index separately charts returns on early-stage VC investments versus combined late- and expansion-stage VC investments.

For example, for the 15 years ended December 2012 and 2013, the early-stage index earned a return of 68.8 percent and 82.07 percent, respectively, while the late- and expansion-stage index earned 8.6 percent and 9.37 percent over the same periods—much closer to the returns to the S&P 500 cited above.12 It also is important to note that expansion- and later-stage investments depend on successful early-stage investments for their existence—again demonstrating that value creation through such R&D investments follows a natural order.

These issues will be revisited in more detail below. The section immediately below examines a variation on the coin flip game (Game 2) in which the natural order of the game is interrupted.

Game break: a ‘virtual time machine’ trump card

Imagine Player 1 in Game 2—in which selling a game ticket is allowed—is holding an “in the money” ticket after Stage 3. That is, “heads” has resulted in three consecutive coin flips and the reference price of the ticket has appreciated 10 times, from $5 to $50. Player 1 now has a 50 percent chance of converting that into $100, but only if “heads” results yet again on the fourth coin flip.

Before the last flip, Player X approaches Player 1 and offers to buy the ticket—but for only $5. Player 1 is still speechless when Player X invokes a special rule—he

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7 See draft, note 1 above, at paras. 12, 17, and 19.
9 Examples of deals and the profiles of established company acquirers are described in the press release cited in note 8, above.

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10 See note 8, above.
puts down his “virtual time machine” (VTM) trump card, an official game card that states clearly (in writing) the following rights, terms and conditions:

- Holder of this VTM trump card may temporarily take control of Game 2 to conclude a transaction.
- Holder may buy another player’s “in the money” game ticket based on any reference price from any prior stage of the game.
- That player must sell the game ticket to the Holder at that price, and may not accept any competing offers or exercise other options.

Player 1 then awakens from the nightmare. Of course there is no “virtual time machine.”

Player 2 now approaches with an offer above $50 while the game ticket dealer is about to call in last offers and make the fourth and final coin flip. Player 1 must now make a decision.

**BEPS discrepancies with hard-to-value intangibles**

Several high-profile companies that have transferred hard-to-value intangibles have come under scrutiny for BEPS. Disputes involving Amazon.com Inc. and Veritas Software Corp. were tried in the U.S. Tax Court, where Amazon’s case is still pending, while Apple was the focus of Senate hearings.

In all three cases, the companies reported technology transactions with foreign affiliates in low-tax jurisdictions that included a transfer of rights to continue long-existing R&D programs that already had realized substantial commercial success. Generally, the foreign affiliates obtained all non-U.S. rights to existing company intangibles, including the rights to develop, own and exploit these and related future intangibles in perpetuity.

These cases demonstrate an uncanny, recurring pattern. That is, the disparity between the government and the taxpayer valuations of the transferred intangibles consistently differs by a factor of 10 or more—that is, it equals or exceeds $10×. Discrepancies of this order of magnitude unavoidably point to exit multiples sought by VCs.

But recall that VC investors can hope to achieve exit multiples greater than $10× in only about 25 percent of cases—according to the recent quarterly data cited above—and they experience at least as many losing and break-even investments.

In fact, longer-term VC fund returns expressed as a multiple of exit values would be closer to $1.3×, which would result from their typical patterns of yielding only one or a few “home runs”—investments resulting in a payoff of $4× or more—combined with many modest, break-even and less successful outcomes.

While the discrepancies noted above may not be a precise, one-for-one comparison with a VC fund’s targeted exit multiples above $10×, precision is not the issue here. Generally, in these cases involving R&D rights, both the government and the taxpayer compute the net present value of transferred technology intangibles using forecasted income streams derived from the same or similar data (for revenue and costs in specific years). The vast differences in these valuations in large part are not attributable to disagreements about the underlying data—nor could that data produce such huge differences. Rather, these differences betray fundamental flaws in assumptions and interpretations of facts and circumstances. And, one must ask, how is it that these foreign affiliates in low-tax jurisdictions so consistently and convincingly beat VCs at their own game?

To date, no R&D efforts have yielded virtual time travel techniques, so rewinding the clock to acquire late-stage technology at the early-stage price is not an option. In effect, however, something similar has been done, with the same effect on the results.

Focusing on Veritas Software Corp. v. Comr., where a greater amount of information has been made public, the opinion notes that Veritas was the largest storage software company in the industry at the time it transferred R&D rights to its Irish affiliate in 1999. A public company since 1993, it was well beyond any of the VC funding stages by this time. Indeed, Veritas would soon join in the S&P 500, in 2000.

Furthermore, the company had secured major customers like Sun Microsystems, HP and others. When the Irish affiliate acquired R&D rights from 1999 forward, the risks associated with subsequent improvements and enhancements to the company’s successful products did not reflect the early-stage risks. Those risks were incurred well before the company went public and its products were successfully commercialized.

Additionally, the transferred intangibles included development rights to all proprietary technology and underlying intellectual property. This broad scope of rights did not reflect the restricted rights that a technology company would offer to a licensee at arm’s length. With development rights, a licensee might be able to engineer the same or a competing technology, obviating its need to license and opening the door for it to compete with the licensor.

Indeed, the Veritas decision makes clear that these circumstances were of the utmost concern to the company and, according to Veritas’ Dec. 31, 1999, form 10-K, its “principal competition in the storage management products area consists of internal development groups of current and prospective [OEM] customers, which have the resources and capability to develop their own storage management solutions.” Under “Competition,” the 10-K lists various licensee customers including Compaq Computer, HP, Microsoft and Sun Microsystems. Should one of these licensees have gained full access to use Veritas’ technology to develop its own competing alternative, the effects likely would have been devastating to Veritas’ very existence.

Undoubtedly, the original equipment manufacturer (OEM) license agreements used in the taxpayer’s valuation as comparables would have restricted the licensees from any rights to develop or derive new technology using Veritas’ own—indeed, the decision describes some of the licensees as among Veritas’ feared competitors. In light of the dramatically different rights in licensed intangibles, the taxpayer’s OEM license “comparables” apparently are not so. These reflect a few of the facts that highlight the fully developed nature of the
Veritas technology and products, and the mismatches in contexts that underlie the taxpayer's valuation.

However, the most flawed assumption is one that involves some time travel. That is, a short "useful life" was imposed on the transferred intangibles even though the intercompany contract explicitly provided perpetual rights in the intangibles for the purpose of developing future intangibles. This assumption of a limited useful life had a major impact in producing a taxpayer valuation that was one 10th or less of that arrived at by the IRS's experts.

When risk is assumed, a critical question is, "When?" For example, it is critical to avoid "allocating" risks ex post when the outcomes associated with those risks, such as the successful commercialization of a product, already are known. In the author's view, transfer pricing analysis of risk often is fraught with mismatches in timing and a misunderstanding of when risk can be attributed to parties to the transaction. This problem often contributes to substantial mis-pricing of intangibles transactions and results in BEPS.

A predominant factor explaining higher early-stage returns is the "lower level of uncertainty"—risk—in future outcomes when an early-stage investment is made, taking into account all known outcomes to date. These same principles apply in most markets, including residential housing and the stock market as obvious examples. One must factor in past pricing and performance as well as expectations about the future. This does not mean that risk-taking on its own makes one rich—of course, returns to risk cut both ways. As noted in the current paragraph 1.45 of Chapter 1 of the OECD guidelines, "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."

**Risk management and the nature and sources of uncertainty**

Section D.2.1 of the discussion draft draws needed attention to the "nature and sources of risk" and highlights that risk is assumed by an individual company with virtually every action it takes, every day that passes and every dollar it spends. Many of those risks are simply inherent to the business itself—referred to as "core risks" in paragraphs 46, 63 and 67. For a mining company, a core risk would be commodity price risk; for a manufacturer, plant and capacity utilization, for example. Such risks may be external (market prices) or internal (effective execution and efficient use of resources), but they demand daily attention from business managers regardless.

As paragraph 41 notes, outcomes in executing primary business operations may be uncertain, but core risks relate to the company's core competencies and potential competitive advantages. It is in facing these risks that the firm is able to create value—for its customers, shareholders, other investors and stakeholders. Value creation results when taking these core risks results in successful outcomes. The risk management function is an essential part of executing the overall management function in this particular context. Paragraph 54 under "Risk management" encapsulates this point as follows:

Risk is inherent in commercial activities [and is often] sought out and assumed by companies in order to generate profit-making opportunities...[T]he appropriate management of these risks affects a company's performance. Risk management, therefore, does not eliminate risk but assesses risk together with the associated opportunities and determines appropriate risk mitigation strategies.

The flip side of this ability to capture value is seen in the consequences that arise when risk management is unsuccessful. Paragraph 42.b highlights uncertainties associated with business execution, and the "effectiveness of processes and operations," and notes that "breakdowns can have a crippling effect on the company's operations or reputation and threaten its existence."

Risks related to timing issues highlighted above also can have a critical impact. Paragraph 42.b further illustrates how management decisions must manage time effectively, and consider the timing of multiple different outcomes, including those it can and cannot control. Timing issues in relation to the actions of competitors have a major impact, as the draft notes,

whereas successful management of such risks can enhance reputation...In other circumstances, the failure to bring a product to market on time, to meet demand, to meet specifications, or to produce to high standards, can affect competitive and reputational position, and give advantage to companies which bring competing products to market more quickly, better exploit periods of market protection provided by, for example, patents, better manage supply chain risks and quality control.

Real options provide a good example of how risk management leverages time, information and risk to generate opportunities for greater value creation. Real option value sometimes is discussed in a transfer pricing context, including in cases involving hard-to-value intangibles. In fact, both "internal R&D" and "external R&D" exemplify real options.

For example, an option to make follow-on investments in a successful project—after the outcomes of earlier phases are known—represents a real option. Real option value increases with the continued success (or anticipated success) of a project, enhancing the value of the initial investment just as the value of an option to buy a share of stock increases with the stock price. Even if the earlier project phases are not profitable, the extent to which they increase the value of potential follow-on investments also affects the value of a real option.

Importantly, the downside risk of a real option is limited, as the cash investment is not committed until the option must be exercised—that is, until the decision to make the follow-on investment must be made. Thus, pulling the plug on an unsuccessful initial investment also reflects real option value.

Decisions on expanding successful projects and abandoning unsuccessful projects—and reallocating real resources and cash between them—are associated with the real option value behind those projects. Individual real options, such as an R&D project or a startup company, for example, can be aggregated into portfolios that also represent real options such as an R&D program of an established company or a portfolio of startups in a VC fund.

Additionally, like options on traded assets and securities, the longer the period before it must be exercised,
the higher a project’s real option value. Thus, an earlier-stage investment has greater real option value—in the form of flexibility regarding later expansion rounds or, alternatively, pulling the plug—than do later-stage investments, all else equal. Importantly as well, options on risky investments are more valuable than options on safe investments because of the flexibility those real options provide, along with their ability to limit downside risk.

Given the levels of expertise and sophisticated risk management an R&D program requires, it is hard to imagine how, for example, an overseas affiliate could assume risks related to an R&D program in which it had no prior involvement and, often, no technical or managerial experience to lead ongoing development.

That said, one should not conclude that, at arm’s length, financial investors playing no active risk management role cannot assume risks related to R&D programs or similar investments—and correspondingly realize the potential returns associated with them.

To the contrary, in arm’s-length arrangements between VC fund managers (general partners, or GPs) and the independent financial investors in the fund (limited partners, or LPs), LPs participate in realizing substantial returns reflected in overall VC fund returns discussed above. This is because a substantial proportion of these returns relates to the early-stage timing of these risky investments—returns that the GPs and the LPs enjoy together.

However, before these proceeds are distributed to the GPs and LPs, a successful fund must first pay out a “carried interest”—usually around 20 percent of total fund profits—to the GPs, along with an annual management fee of between 1.5 percent and 3 percent of total investments under management.

In this way, the GPs are rewarded a premium for their risk management role, commensurate with the unique capabilities, skills and experience they bring—without which neither the GPs nor the LPs have opportunities to realize extraordinary early-stage returns in R&D-focused startup companies.\(^\text{18}\)

### Time, information and experience—three keys to certainty

Another way to understand the nature and sources of risk or uncertainty may be to ask what are the nature and sources of certainty. It seems any response to this question should include three elements: time, information and experience. While there may be other elements or aspects of certainty, this list is enough to reinforce the OECD guidance on the central role of risk management in understanding arm’s-length behavior.

**Time.** In business, as in life, no one can predict the future. However, operating a business requires that critical decisions be made *ex ante*—before the fact. In this respect, the passage of time holds one key to certainty. *Ex post*, the outcomes of actions are revealed as they interact with others’ actions and events. This informs the next decision, and the next, and so on.

Of course, businesses proactively execute on risks that they can control. They do not sit idly by as time passes, like Player 1. But time not only reveals outcomes over which businesses might exercise some control, it alsousherers in others that they cannot. Furthermore, with effective risk management, businesses manage the efficient use of time, as well as the timing of their decisions and actions—often turning uncertainty itself to their advantage in the process, as noted above with regard to real options.

**Information.** Information, however it is obtained, is another key to certainty. The more information a business person has to analyze about factors that might affect the outcome of a decision, the greater the probability of a good decision—one that produces, or contributes to, a successful outcome.

**Experience.** Experience is a reflection of the ability of the business or individual to leverage time previously spent while exposed to past events, as well as knowledge and information about the results of past actions and practices. When those experiences share common elements with actions and events expected to occur in the future, experience itself helps to “answer” some questions in advance—perhaps not with certainty, but with a higher probability of success.

Over time, experience leads to expertise. Experts are not unlike artists and athletes—they are good at what they practice—and business professionals are no different. Appropriately, the guidance refers to specialized areas of business expertise that often are unique to multinational operations. The words used to describe these aspects of risk management are appropriately placed throughout the draft as well, including, for example, “expertise,” “strategy” and “strategic,” “decision-making” and various derivations of these and other terms.

In summary, risk management applies experience and expertise in making critical decisions at the right time, using the best available information. Given these capabilities, it is difficult to imagine that true risk management ever would resort to flipping a coin.

### When risk management is absent

The limitations of the coin game illustration will be more than apparent by now. While the game demonstrates some relationships between risk, timing, information and price, there is no role for experience and expertise. Indeed, no one can contribute special skills or expertise to avert or manage outcomes, or exploit other opportunities related to the risks taken. Thus, risk management cannot exist in the game without significant changes to its rules and assumptions. Player 1 is simply in it for luck—and with a 6.25 percent chance of winning, it’s quite a long shot.

If the absence of any risk management capability exposes some of the game’s limitations, it serves as a helpful illustration for the same reason. In this respect, the game resembles the circumstances of parties to some problematic intercompany arrangements that create mismatches between risks associated with core capabilities and the associated returns.

In these cases, related parties may be contractually allocated risks that they have not—and, realistically, could not have—assumed given their functions, assets and capabilities. These parties may not be able to adequately perform the core functions or manage the key risks associated with some operations even though they

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\(^\text{18}\) See note 6, above.
may contractually have been allocated risks associated with those operations. As discussed above, generally when risk management is contracted to other parties at arm’s length, it is to experts in managing that particular kind of risk—such as insurers, or general partners in a VC fund.

Furthermore, these parties may be legally assigned rights to reap greater rewards for related risks that they do not take and cannot control. The effect of this mismatch would be that those parties that can and do control those risks must relinquish the associated profit potential. To the extent that this may occur in practice, it would increase the likelihood of BEPS.

When these arrangements take place in later stages of a company’s life cycle or its development of products and services, they may reward some parties for risks that already were assumed and managed by other parties. For example, multinational entities may acquire R&D intangibles that are at late stages in their development and commercially successful—in which case, key early-stage risks already have been resolved.

When mismatches between risk allocation and the real capabilities to assume risk occur together with mismatches in timing as to when risks are assumed, the potential for BEPS is compounded. Indeed, taken together, these effects can produce staggering discrepancies between the price paid and a price to which independent parties would agree given the risks they naturally assume in light of their own capabilities, options and opportunities.

In many respects, the examples and illustrations above focus on issues related to hard-to-value intangibles resulting from early-stage investments in R&D. This is among the major areas of focus in the BEPS discussion, as demonstrated by its place on top of the list of issues that may require special measures.

Nevertheless, the same types of issues may apply wherever value is created through a sequence of interdependent steps. In each case, one must identify the key risks, as well as the parties that realize the consequences of those risks, and whose responsibility it is to manage them. The same natural order described earlier is reflected in paragraph 49 regarding product risk:

[Product risk] can have a significant impact on the developer of the product, but it will also have an impact on the volumes manufactured by production companies and sold by distribution companies; there may be an impact on cost of borrowings and on reputation of all parties, and ultimately on commercial viability. Although the manufacturer or distributor strictly speaking may not be allocated product risk, they are affected by the outcome of product risk because of the group interdependencies.19

Indeed, the revised guidelines are comprehensive in addressing the entire value chain, providing helpful illustrations of the assumption of risk throughout. Examples capture practical realities associated with business risks, as experienced managers must make daily or frequent decisions with large impacts not only at their own operational, divisional or geographic level, but potentially throughout the firm.

Many of these examples illustrate the high degree of interdependence among affiliates and operations at different levels of the market.20 Because of these interrelationships, the draft properly calls for a complete analysis of the multinational operations and an examination of how value is created at all levels. This is accomplished not only by analyzing various functions and activities—by asking the who does what? questions—but with a thorough inquiry into when and where risk is assumed and, critically, how risk is managed.

19 See discussion draft, 23 Transfer Pricing Report 1170, 1/8/15.
20 See discussion draft, paras. 48 and 50-52.
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February 5, 2015

Ref: 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,

We thank the OECD for the opportunity to comment on its Discussion Draft on BEPS Actions 8, 9 and 10, Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures), issued 19 December 2014 (the Discussion Draft). We have each worked for many years on transfer pricing matters in the U.S., many of us at different times in both private sector and government roles. We are writing in our personal capacities, not on behalf of a client, employer, or any other person. Our sole objective is to assist in the development of tax rules that are clear, practical, and susceptible to consistent application globally.

We support the Discussion Draft’s two-step approach: first delineating the actual transaction based on the parties’ contracts and behavior, and second, determining an arm’s length pricing solution taking into account the parties’ respective functions, assets and risks. Further, we believe the Discussion Draft provides helpful new guidance on the identification of risks potentially relevant in pricing a transaction. That said, review of the Discussion Draft suggests that much work remains to be done before clear and administrable guidelines are in place.

In many respects, we think the Discussion Draft is too theoretical and its expectations of the international tax system impracticable. In its current form, we fear it creates more uncertainty for tax authorities and taxpayers, and could have the unintended consequence of weakening the commonly accepted, objective guideposts in a transfer pricing analysis, leading taxpayers and tax authorities to take positions that are more subjective and perhaps more opportunistic. A more careful balance must be struck between achieving the central goal of the BEPS initiative (ensuring that profit allocations align with value creation) and minimizing administrative burdens on taxpayers and governments.¹

In an effort to assist in achieving that balance, we provide general comments and paragraph-specific comments below. We begin with an executive summary of our main points.

¹ Although the OECD’s recent discussion draft on Action 14 (making dispute resolution processes more effective) is outside the scope of these comments, we note the direct relationship between the clarity of the substantive rules and the ability of taxpayers and tax authorities to manage the administrative burdens that arise with more complicated and uncertain rules. It is not clear to us, based on past experience and the direction of the Action 14 draft report, that the OECD appreciates this relationship sufficiently or that the countries participating in the BEPS project share our view that improving existing dispute resolution processes is an essential component of and critical to the success of the BEPS project.
Executive Summary

i. Transfer pricing, like tax administration generally, needs practical rules that can be administered efficiently. Clear, practical, efficient rules should be paramount in an area like transfer pricing given its importance, pervasiveness, and the compliance demands it already places on taxpayers and tax authorities. Clarity and administrability are crucial for taxpayers and tax authorities to avoid becoming overwhelmed by disputes and mushrooming double-tax inventories.

ii. The Discussion Draft identifies a wide range of considerations that may distinguish MNE group members from independent parties, e.g., the moral hazard discussion and observations about risk and reputational interdependence, and suggests that a transfer pricing analysis needs to account for such things. The Discussion Draft says little about how this is to be done and says nothing about materiality or about tempering the demands of a transfer pricing analysis to reflect the availability of market-based information.

iii. The Discussion Draft suggests that taxpayers need to align transfer prices with value creation for the MNE group as a whole. The insistence on rationalizing the entire value chain may invite some tax authorities unduly to expand the scope of a transfer pricing analysis and to substitute economic theories of value creation for marketplace pricing. The Discussion Draft should discourage tax authorities from seizing on the nuances of an overly sophisticated standard as an excuse for throwing aside market benchmarks and applying some economic theory of value creation.

iv. To the extent possible, a transfer pricing analysis should build on established market benchmarks. Market benchmarks provide common, practical standards. Adjustments to market benchmarks and the importation of economic theory should be kept to a minimum to reduce compliance burdens and the occasions for taxpayers and tax administrators to engage in subjective, opportunistic tax positioning.

v. Inappropriate income shifting through non-arm's length transfer pricing is a significant challenge for the international tax system. We strongly believe the response should be focused on mis-pricing practices without casting aside basic principles. To that end, we recommend the OECD Transfer Pricing Guidelines identify more clearly the potentially abusive situations it seeks to target and address those with practical guidance. Such guidance should address specific issues of concern, such as "cash boxes."

vi. We recognize there are numerous complexities in applying a robust arm's length transfer pricing analysis. We would urge the OECD not to respond to these complexities by putting unreasonable burdens on taxpayers. Any forthcoming guidance should adopt a flexible approach that focuses on the reasonableness of the taxpayer's pricing method.
General Comments

1. Transfer pricing, like tax administration generally, needs practical rules that can be administered efficiently. Clear, practical, efficient rules should be paramount in an area like transfer pricing given its importance, pervasiveness, and the compliance demands it already places on taxpayers and tax authorities. To the maximum extent possible, a transfer pricing analysis should build on established market benchmarks. Such benchmarks serve to guide and to constrain transfer pricing outcomes. Adjustments to market benchmarks should be kept to a minimum to reduce compliance burdens and the occasions for parties – taxpayers and tax administrators alike – to engage in subjective, opportunistic tax positioning. We find the Discussion Draft to be overly nuanced and theoretical in many respects, as if it were possible to take into account all the consequences of “group relatedness” and even modest increments of value. The approach is so refined as to be unrealistic. See for example ¶21. To borrow from the court’s opinion in the U.S. landmark transfer pricing case, *US Steel*, the draft would impose “a crippling degree of economic sophistication” on an exercise that should seek reasonable outcomes, not perfect alignment between controlled and uncontrolled fact patterns.

2. The Discussion Draft is inconsistent in its support of fundamental, long-standing transfer pricing principles. On the one hand, the Discussion Draft supports the traditional transfer pricing approach, which is premised on separate entity accounting, analysis of the relevant economic contributions of the parties (functions, assets, and risks), and benchmarking to comparable arrangements. Thus, the Discussion Draft recommends a straightforward, two-part analysis:

   (i) an accurate delineation of the transaction (starting with the parties’ contractual arrangements but informed by actual behavior); and

   (ii) comparing the conditions with those that would obtain between unrelated parties in order to determine a price.

On the other hand, the Discussion Draft seems in many instances to undercut separate entity accounting by emphasizing group attributes (e.g., ¶¶ 10, 21, 40, 41, 48, 56 and 79) and suggesting that tax authorities have the power to “non-recognize” controlled transactions of a type that would not be entered into by uncontrolled parties (e.g., ¶¶ 82, 83, 89 and 92). The latter notion is at odds with current OECD Transfer Pricing Guidelines (and the Discussion Draft itself), which make clear that a controlled transaction may satisfy the arm’s length standard even though it is not a transaction that would occur between independent parties. Cf. ¶¶ 82, 84, 88 and 89. Such transactions should be priced, and ordinarily can be priced within reasonable levels of accuracy using the two-part analysis laid out in the Discussion Draft. For transfers of “hard to value” intangibles, where information asymmetry impedes the tax authority from determining an *ex ante* price, it might be appropriate to reallocate profits using hindsight, as suggested in Part II of the Discussion Draft. But we strongly recommend that the Discussion Draft be consistent in emphasizing the importance of adherence to Article IX concepts, except in those unusual cases in which a reasonably reliable *ex ante* pricing solution cannot be found.

3. In that regard, we do not believe that the “moral hazard” concept or the interrelatedness of an MNE group should allow tax authorities to non-recognize transactions or undermine the fundamental principles underlying Article IX - separate-entity accounting and the arm’s length standard. Some proponents of the moral hazard line of reasoning seem to argue in effect that

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*U.S. Steel Corp. v. Commissioner*, 617 F.2d 942, 951 (2d Cir. 1980).
controlled and uncontrolled transactions are, by definition, non-comparable because economic interests are aligned in the former but not in the latter. We agree that controlled and uncontrolled situations may be different in this respect but this is hardly a new or even recent observation. It has always been the case. Nonetheless, the CFA has made clear that the arm’s length standard must and will remain a bedrock of the OECD Transfer Pricing Guidelines - we think that view is correct.

4. We are concerned that the repeated references in the Discussion Draft to group integration, interdependencies (such as reputational interdependence), synergies, and value chain analysis, may, unless put in clearer context, encourage taxpayers and tax authorities to depart from standard transfer pricing practice and make transfer pricing allocations based on vague, subjective notions of “relative contribution,” completely untethered from the market. There is no doubt that corporate organizations may enjoy synergies and that there may be subtle and sometimes pervasive elements of value enjoyed by a corporate group that do not find their way into recognized transactions and thus are not reflected in transfer prices. See Ronald Coase, The Nature of the Firm, 4 Economica (Nov. 1937); Richard Caves, Multinational Enterprise and Economic Analysis (Cambridge University Press, 1982). But the Discussion Draft seems to signal an ambition for transfer pricing to ferret out and take into account each element of value no matter how modest, emphasizing throughout the paper the integrated nature of MNE activities, e.g., in the way that risk is spread and managed by all members of a group (see ¶¶ 10, 21, 40, 41, 46, 48, 56 and 79), the interdependence of affiliates, and the importance of synergies. This ambition is further evidenced by the Discussion Draft’s insistence on the need to examine the entire value chain when analyzing any single transaction to ensure that transfer pricing results align with value.

The problem with proceeding on this basis is that there is no consensus – among economists, transfer pricing professionals, tax administrators, or others to our knowledge – for how to quantify the relative contributions of MNE group members. It is one thing, for instance, for transfer pricing to agree on the arm’s length compensation paid to a nurse, it’s quite another to ask transfer pricing to examine the health care system value chain to agree on the value contribution of a nurse. One could examine the role of a nurse in managing key risks and driving operational efficiencies for a hospital group but, modesty aside, we would not know how to effect this in a transfer pricing analysis. The Discussion Draft should put “off limits” the vast majority of MNE group synergies by reasserting that a transaction will be imputed only if one would expect independent parties to pay for such transaction; the Discussion Draft should make clear it is not licensing taxpayers or tax authorities to impute transactions and to move income around to achieve some notion of economic balance or relative contribution. We think this is implicit in paragraph 7.13, which prevents parties from making transfer pricing adjustments to account for affiliation benefits in the absence of a recognized transaction.

There are many other statements in the Discussion Draft that seem to highlight “nature of the firm” like features. To the extent possible, a transfer pricing analysis should build on established market benchmarks and avoid complex refinements for interdependencies and synergies and the like. The uncertainty surrounding such refinements will leave companies unsure of their tax obligations and will lead to disputes with tax authorities, taking time and resources from taxpayers and tax authorities alike. This is not in anyone’s interest.

5. The Discussion Draft needs to provide greater clarity on the critically important points of investor risk and return. A lack of clarity on these points will lead to conflicting interpretations and intractable disputes.
In the marketplace, an investor attracts the residual gain or loss of an enterprise. The investor's claim to the return does not depend on whether the investor is knowledgeable or is meaningfully engaged in the process – no one questions a trust's right to income or responsibility for losses notwithstanding that the trust may be 100% managed by an external trustee. People get paid to manage other peoples' money. How much they get paid presumably reflects their talent and level of responsibility. Depending on the facts, such compensation can be substantial.

We understand, of course, that some argue that a passive investor in a controlled group (aka, a cash box) should not be allowed to earn the full residual return from an investment; they argue that the profit and loss should be allocated to the entities employing the persons responsible for the outcome, leaving the investor entity with a more debt-like return. This argument comes in two versions. The first version conditions denial of the full residual return to the investor on a threshold determination that the investor entity lacks the minimum required substance. “A man and his dog,” to use a common expression, may not be not enough, but once the investor meets the required substance threshold, the full residual return to the investor is respected.

The second, more aggressive version of the argument by-passes the question whether the investor has meaningful substance and subordinates the return to capital in favor of the return to labor and other inputs, effectively treating the full excess return as a group benefit to be spread among all entities that contributed to it. Under this argument, the investor has no particular claim to any portion of the residual return (or responsibility for the loss); that return is distributed (on some basis) among all persons who contribute to its realization.

The Discussion Draft leaves us unclear of its position on this important issue. In places, the text seems to have a modest and we think appropriate goal of ensuring that persons managing risk are compensated at arm’s length for the services performed – compensation that could be very substantial – as any manager or investment advisor would be. See, e.g., ¶ 77. In other places, the discussion seems to elevate the importance of risk management over the importance of risk bearing, see, e.g., ¶¶ 57-63, 78, implying that risk managers have a superior claim versus the investor to the residual profit.

We believe that investment risk should, and does, attract residual profit in the market, but our paramount interest in raising these issues is to achieve clarity. It is in no one’s interest for this issue not to be clearly resolved in the guidance.

6. An example might help crystallize thinking and provide needed clarity about this key issue. Assume that highly-taxed parent company (P) capitalizes lightly-taxed subsidiary (S). Following good corporate governance practices, S makes the decision to hire and fund an affiliate (A), with its “best in class” research team, to pursue “blue sky” biologics R&D for the account of S. S has the capability to monitor and assess A’s activities at a fairly high level, similar to the level of monitoring performed by a corporate Board of Directors, and in fact does so, but the operational aspects of the R&D project are managed by A in consultation with more senior executives at P who direct and oversee the formulation of global R&D strategy for the group as a whole.

The parties agree that S will reimburse A for its expenses and pay A either (as agreed at the outset) a fixed mark-up on its expenses or a preferred share (“off the top”) of any profit from the sale or commercialization of resulting products (similar to arrangements commonly seen in oil and gas exploration deals), and that S will retain the balance (or suffer the loss). The parties also agree that S will provide a return to P for its executive oversight by reimbursing P, with a markup, for an
allocable portion of the fully loaded costs attributable to the personnel that perform the executive oversight.

We think that in this example, absent other facts, the traditional arm’s length pricing analysis can and should apply, meaning that each party should be rewarded based on its functions, assets, and risks, using a robust and realistic \textit{ex ante} analysis, and making use of all probative information available at the time of the transaction. We believe the focus should be on finding market analogues for the contributions of the parties and determining on that basis whether their economic arrangement is reasonable. We do not believe that the tax inspector in either jurisdiction should be authorized to disregard the capitalization of $S$, or to treat $A$ and/or $P$ as the residual profit-taker, or to choose non-recognition if that approach benefits the government. We do agree that, in some situations, it may be appropriate to apply \textit{ex post} pricing in accordance with the Option 1 special measure described in the Discussion Draft but we would expect those circumstances to be the exception.

7. In the foregoing example and generally, any methodology that proposes to re-allocate profits (residual or otherwise) within a group must be tempered by the fact that no country will be willing to accept a re-allocation of losses. To expect otherwise defies experience. A taxpayer may explicitly adopt a transfer pricing method that routinely shares profits and losses, of course, but it would not be appropriate for a country to adopt rules that regularly reallocate profits to itself under situations where that country would not accept a reallocation of losses. Transfer pricing rules and enforcement are successful only when the guidance applies in a neutral, two-way manner, equally to a country whether it hosts the buyers or the sellers, whether the transaction represents in-bound investment or out-bound investment, and whether the transaction produces a gain or loss.

8. The treatment of risk in the foregoing example and in the discussion generally should be consistent with the guidance already agreed by member states and included in the comprehensive discussion of risk in Chapter IX. Chapter IX’s immediate concern is with business restructurings, but the principles set forth relating to the treatment of risk (¶¶ 9.17-9.38) should be considered to have broader application. Paragraph 9.23 defines “control” over risk as (i) “the capacity to make decisions to take on the risk (decision to put the capital at risk)” and (ii) the “decisions on whether and how to manage the risk, \textit{internally or using an external provider}.” [Emphasis added.] The paragraph goes on to provide that the company must have people who exercise authority to control the risks, and further, “when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that other party.” Paragraphs 9.23 and 9.24 provide further detailed guidance (the principal must be capable of assessing the outcome of day-to-day risk management services performed by another) and an instructive example describing the relationship between an investor and a fund manager. Other key points reflected in these paragraphs are:

- The capacity to bear risk is important; thus, the contractual allocation of risk to a party incapable of bearing the risk is suspect under the arm’s length principle (¶¶ 9.29-9.31)
- The fact that independent enterprises do not allocate risks in the same way is not a sufficient basis for non-recognition, although it may justify special scrutiny (¶ 9.36)
• A tax authority may re-assign the consequences of risk allocation in exceptional circumstances (i.e. “where a reasonable solution cannot be arrived at through a pricing adjustment”) (¶ 9.38)

Returning to the example in Comment 6 above, under Chapter IX principles, it is unlikely that the A or P tax authority could ignore the allocation of risk to S (much less disregard the capitalization of S). Rather, the focus would be on whether, taking into account all of the economic contributions of A and P, there is a pricing solution. On the facts of our example, the question likely would boil down to whether, under the traditional analysis of functions, assets and risks, the rewards to A, P, and S, respectively, are in line with their respective value-creating activities.

9. As it stands, the Discussion Draft leaves us uncertain how it views the role of the investor in a controlled group setting and the extent to which the investor’s entitlement to its return is judged by standards similar to or different from the standards applied in the marketplace. A typical investor in the marketplace controls and manages investment risk by deciding how much to invest, in what, on what terms, and for how long. Many investors don’t have meaningful control beyond these matters yet no one questions their right to the full residual return. If the text intends to depart from the arm’s length standard by taking the view that this type of risk management does not support an investor’s residual return in a controlled group context, it should say so plainly. On the other hand, if the text’s seemingly cramped view of an investor return is limited to investors who lack even the ability to decide how much to invest, with whom, and for how long, etc., this should be clarified.

Comments on Specific Paragraphs

In this section, we comment on specific paragraphs in the Discussion Draft. For convenience, our comments follow the sequence of the paragraphs; they are not listed or ranked by importance.

10. **Paragraph 2** notes that, in establishing the conduct of the parties, the interaction between the parties and how that interaction contributes to the “rest of the value chain” should be examined. As noted above, we are concerned that reference to such a value chain analysis, unless put in clearer context, may encourage taxpayers and tax authorities to depart from standard transfer pricing practice and make transfer pricing allocations based on vague, subjective notions of “relative contribution.”

11. **Paragraphs 3-4** indicate that it may be necessary to amend or supplement a written contract to reflect the actual conduct of the parties. Paragraph 4 includes an illustration where a distributor is performing substantial marketing and advertising activities which were not addressed by the terms of the written agreement between the parties. While conduct outside the scope of a contract is clearly relevant to the pricing of related party arrangements, the commentary should note that the analysis must also consider the conduct of independent parties in this regard, for example the possibility, relevant to the illustration in Paragraph 4, that independent distributors likewise perform extra-contractual marketing and advertising activities.

12. **Paragraph 6** is apparently intended to illustrate the principle that conduct trumps contracts where conduct diverges from contracts. But the example focuses on whether the label (characterization) given to the transaction by the parties is accurate. If the example focused simply on the parties’ actual respective economic contributions, we are confident that the transaction delineated could be properly priced, without the need to ascribe a label to the transaction. The
example also raises the question of whether under the agreement S must pay fees even if that results in operating losses.

13. **Paragraph 7** could be seen as encouraging tax authorities to move income among members of an MNE group based on notions of relative contribution by suggesting that they impute intercompany transactions whenever they find valuable synergies “created through deliberate concerted action.” One would expect all action in a well-run MNE to be both deliberate and concerted, at least at a high level. On its face, we fear there would be no meaningful limit to the opportunity to move income among members of an MNE group on the basis that coordinated action produced group value. We note that valuable synergies are created all the time in the marketplace between and among independent parties without compensation. This happens when a software designer releases an application that runs on a third party device, when a civic project increases private property values, when a celebrity impliedly endorses a good or service simply by being seen using it. As we note previously, the Discussion Draft should put “off limits” the vast majority of MNE group synergies by reasserting that a transaction will be imputed only if one would expect independent parties to pay for such transaction; the Discussion Draft should make clear it is not licensing taxpayers or tax authorities to impute transactions and to move income around to achieve some notion of economic balance or relative contribution.

14. **Paragraph 16** suggests that it is always “important to understand how value is generated by the group as a whole [and] the interdependencies of the functions performed by the parties with the rest of the group …” There are many cases in which good external benchmarks are available for pricing a particular transaction or flow within the group trading structure, such that it is not necessary to know what happens in the remainder of the structure in order to apply the arm’s length standard. The risk in such cases is that the local tax authorities will waste resources or be tempted to impose some “fair share” allocation based on system profits rather than normal comparability analysis.

15. **Paragraph 18** suggests that a member of a diversified group would pay a different (lower) price for insurance than a person that is not a member of a diversified group because the former would view itself as having less need for insurance and therefore, impliedly, be less willing to pay for it. We urge that this paragraph be removed. We believe the arm’s length price of a good or service should be based on standard market pricing, subject to normal comparability standards, and not be based on the idiosyncratic value of the good or service to the related party purchaser. Support for this view is found in Commissioner of Taxation v. SNF (Australia) Pty Ltd [2011] FCAFC 74 (Federal Court of Australia, June 1, 2011). The OECD would be inviting mischief if it were to encourage taxpayers or tax authorities to adjust market benchmarks to reflect a related party’s need for a good or service; every pricing decision would be an occasion for dispute if one has to factor into the analysis whether a party needed the item more or less than an independent market participant.

16. **Post-Paragraph 40 (Moral Hazard discussion)** suggests that independent parties may be driven to unify risk bearing and risk management to ameliorate moral hazard concerns whereas members of a controlled group may separate risk management and risk bearing because they are less subject to moral hazard risks in dealings among themselves. The Discussion Draft suggests this difference may be a material comparability concern; some countries have posited it as a basis for non-recognition. We disagree. Moral hazard is everywhere, in everyone’s calculation of short term and long term self-interest, but it does not lead to the unification of risk bearing and risk management in the marketplace and transfer pricing rules should not force this unity on a single member of a controlled group. Rather, moral hazard concerns are addressed in the marketplace
through the tempering influence of protective contract terms (covenants, e.g.) and enlightened self-interest, i.e., the realization of parties to any potentially long term business relationship – which is typical of dealings among controlled group members – that they have an incentive to avoid sharp practices in order to maintain specific business relationships and general reputation. To the extent it is customary (and economically significant) for independent parties to have contract provisions to protect against sharp dealings, a tax authority could reasonably impute such terms into controlled group dealings. We expect it would be very unusual, however, for the imputation of those terms to change the economics. Even assuming that moral hazard is a basis for distinguishing controlled and uncontrolled situations (and we have our doubts), the absence of moral hazard should not serve as a basis for non-recognition of a controlled transaction, nor should it be a factor in normal cases in determining whether the controlled transaction has in fact been reasonably priced.

17. Paragraph 43 suggests that if the parties’ conduct does not follow the terms of their agreement, the agreement may be ignored for purposes of pricing. This can be taken too far. Accommodations are often made in the marketplace that differ from contract terms (e.g., hotel and airline upgrades) but that does not mean the contract terms are not important in setting the price. The better way to address the issue is to ask whether the departure requires compensation; this allows you to consider arm’s length behavior with respect to such departures, rather than to deem the original agreement as being retroactively amended and requiring that it be re-priced.

18. Paragraph 49 could encourage taxpayers and tax authorities to move income among members of an MNE group based on vague notions of contribution and interrelatedness. The paragraph notes the possibility that “production supply problems are not limited in their impact to production operations, but can affect sales volume and profitability for other group companies, and potentially cause reputational harm.” It suggests the same about product risk – i.e., that product risk can be felt throughout the MNE group, with consequences for the product developer, the manufacturer, and the distributor. All of this suggests that consideration should be given in setting transfer prices to the fact that parties in a controlled group may have an interest in the success of others. These observations may be accurate but they are also true in third party dealings – third parties likewise care about the reputation of the parties with which they deal and may be affected by disruptions in their independent supply chains. To the extent the Discussion Draft is suggesting special adjustments for group reputational or supply chain interdependence, we urge against that.

Some tax examiners have cited group reputational interdependence as a reason one member of a controlled group should provide a good or service to another member at a discount. They reason that the service provider (e.g., the MNE group parent) benefitted by avoiding the reputational injury that could have occurred if its affiliate had gone without the service and was unable to perform in the marketplace as a result. One can imagine many scenarios in which controlled group members could suffer reputational harm due to the failure of another member. Does the Discussion Draft mean to suggest that controlled parties must import into a hypothetical arm’s length analysis a set

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While we recognize that the economic interests of separate legal entities within a vertically integrated business may be aligned, there are forces other than transfer pricing rules that drive arm’s length behavior. Joint venture arrangements with unrelated parties commonly impose market discipline on pricing arrangements. Local corporate laws generally require that a board of directors ensure fairness for the local entity -- and local directors are vocal in carrying out this charge. In many countries, works councils or similar employee groups are keenly interested in the roles and rights of their specific legal entity. All of these considerations buttress the transfer pricing requirements that entities pursue their self-interest and act at arm’s length.
of considerations that arise from MNE group reputational interdependence? May, or must, a parent
discount the price of goods to an affiliate to take account that the affiliate’s success (or avoidance of
failure) will secure MNE group objectives?

Whenever a controlled party sells goods or services to another, the selling party commonly realizes
advantages such as reputational benefits or possible synergies. If the selling party were free (or
forced) to reduce the arm’s length transfer price (and thus its income) on account of such notional
and highly subjective benefits, almost any cross-border transaction could become the occasion for
creative tax planning and dispute. To eliminate uncertainty, any forthcoming guidance should
make clear that benefits of this nature do not warrant adjustment to the arm’s length price
otherwise determined for a related party good or service.

It is hard to overstate the confusion – and potential for mischief – that will ensue if taxpayers or tax
authorities import into market pricing the reputational considerations that may affect members of
a controlled group or other considerations based on the de facto interdependence of members.

19. Paragraphs 57-63 elevate the importance of risk management over risk bearing. Paragraph 57 deals with risk associated with the price of raw material in the manufacture of goods. The example cautions that one should not infer how risks have been managed by looking only at the
price terms. It says,

“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
account of its actual costs. The implication of the claim is that the other
group company assumes the risk.”

The text reads, “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.” The text says that if the manufacturer manages the risk (notwithstanding it doesn’t bear it), the manufacturer should be rewarded for that. We agree that services should be compensated, whatever those services are. But the text doesn’t explain why the identity of the person who
manages the risk is the “key point.” Perhaps it’s the key point simply because the example occurs in
the section of the paper titled “Risk management,” so it’s the key point relevant to the topic under
discussion. But if the text means that risk management should attract more of a return than risk
bearing it does not explain why. The distributor in the example seems to get no credit for bearing
the risk under the parties’ contract.

The example in ¶60 deals with a scenario involving product recall risk. It says the contract assigns
the risk to the distributor, but that the manufacturer takes all the steps to ensure the integrity of the
product and “the distributor has no involvement and no capability to assess the risk or effectively
monitor risk mitigation.” “In such a circumstance,” the example states, “the manufacturer should
attract the outcome of upside and downside risk instead of the distributor.” This is not persuasive.
The manufacturer’s activities may affect the quantum of the risk but we do not see how one can
ignore the contractual allocation. If there were a recall, the tax authority of the manufacturer’s
jurisdiction would surely, and rightly, demand that the distributor bear the cost as per the contract.
We fear the Discussion Draft is setting up a double tax problem by disregarding the contractual
allocation and is doing so based on a standard that will be virtually impossible to apply consistently even on a unilateral basis – an evaluation of whether the distributor has done enough to allow it to bear the product recall risk that it has contractually assumed. We also caution that the example posits a degree of certainty regarding responsibility for the product recall risk that is rarely supported by the facts. There may be an occasion when it is clear that a product recall was the fault of the manufacturer but the situation is frequently ambiguous; the fault may lie to some degree with inadequate customer training, installation issues, or maintenance, etc., all of which may be under the distributor’s control. We are concerned by the prospect that, in the event of a product recall, a tax authority will seek to overturn a contractual allocation of risk by taking sides and trying to assign factual responsibility for the underlying problem. This should be discouraged, at the very least by limiting challenges to contractual allocations of risk to well defined situations where improper tax motivation is clear. (See footnote 6 below.)

Paragraph 63 says that where one party owns a commercial asset but does not have the wherewithal to manage it, “the risk associated with exploitation of the asset may be allocated to the party actually performing risk management” and the legal owner of the asset should be treated as “in substance providing only financing equating to the cost of the asset, and should be remunerated on that basis.” This is another instance where the text is not clear but seems to signal skepticism about allowing a residual return to the investor. The illustration appears to assume that risk management services cannot be reliably benchmarked and that the risk of owning commercial assets is small, both dubious assumptions in our view. It is not clear, moreover, what the text means about treating the owner as providing only financing equating to “the cost of the asset.” Is the Discussion Draft deliberate in focusing on the cost of the asset as opposed to its value? How would the principle espoused in the text be applied to the common, arm’s length situation where someone owns a rental property (e.g., a ski condo) and hires a property manager to rent it out? Denying an appropriate return to a party that brings assets to the table and puts them at risk is inconsistent with basic transfer pricing analysis as commonly understood and enshrined in the OECD Transfer Pricing Guidelines.

20. **Paragraphs 65-66** seem to be directed to the pure “cash box” situation but the intended message is unclear. We accept that an entity (A) that commits capital to a project and that retains another (B) to manage the day-to-day operational risks of the project must have the capability to monitor the activities of B and actually perform such oversight to the degree one would expect of a third party investor in similar circumstances if it is to claim returns from the project (other than perhaps a fixed, debt-like return). But we believe that, in contrast, S in the example outlined in General Comment 8 above should be respected and is entitled to claim residual profit (or loss) based on the assumptions in that example.

21. **Paragraphs 81-89** are helpful in that they emphasize the importance of the effort to determine an arm’s length price for a controlled transaction, even if that transaction is not observed between unrelated parties. However, we are concerned that these paragraphs may be read to suggest that a tax authority may disregard a transaction if it concludes, with the advantage of hindsight, that a different transaction would have made more sense for either of the parties. Paragraph 89 says that for a transaction to be respected, it must “offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions . . . compared to other opportunities realistically available to them.” The prospect of a tax examiner second-guessing whether a transaction offers a reasonable expectation of profit is troubling but we are especially troubled to have a tax examiner apply a comparative rather than an absolute yardstick to the question. The text needs to be revised to protect against tax authorities second-guessing the wisdom of transactions and ignoring or re-characterizing transactions they conclude are
suboptimal. (We note that suboptimal transactions are hardly unique to controlled party settings; uncontrolled parties may likewise fail the test set out in the text, which in our view highlights that the text casts too wide a net.)

22. **Paragraphs 90-92** set out an example involving the sale and license of a trademark and concludes that the transaction will not be respected because it "lacks the fundamental economic attributes of arrangements between unrelated parties." We do not believe the facts in the example support its conclusion. The basic transaction of a trademark sale and license back is one that we have observed in the market. The example in the Discussion Draft seems to suggest that an enterprise cannot transfer risk in exchange for a lower, more stable return, a notion plainly at odds with commercial realities. Such transactions are in fact common, even with valuable assets, as a means for sellers to raise cash while retaining long term use of an asset. Moreover, the example is unrealistic in suggesting that a transaction may be non-recognized if the parties take tax consequences into account - unrelated parties typically consider the tax consequences in assessing commercial opportunities. To us, the question presented by the example is simply whether the pricing is reasonable, given the respective functions, assets and risks of the parties. We recommend that you replace this example with one that is more clearly and narrowly focused on the perceived abuse. In addition, the guidance should make clear that “de-risking” transactions are perfectly acceptable, assuming they pass muster under the principles set forth in Chapter IX of the OECD Transfer Pricing Guidelines.

**Comments on Special Measures**

In this section, we comment on the potential special measures set forth in Part II of the Discussion Draft.

We think the question of “special measures” should be approached with extreme care. Special measures should not be a substitute for good faith efforts to price transactions using well-established principles and valuation methods. Especially in an era of shrinking tax compliance resources, we fear that special measures might easily become a “short-cut” for both taxpayers and tax authorities. Speaking from our experience, current rules are almost always sufficient to address

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4 See Agreement for Trademark Assignment and License Back, at Error! Hyperlink reference not valid. (involving a U.S. company that purchased from an unrelated party the rights to the **Snorkel** trademark in territories outside the U.S. for a lump sum with an agreement to provide the seller a perpetual, royalty-free, irrevocable license to the trademark in all countries except the U.S. and Canada).


6 The transfer pricing provisions of the Canadian Income Tax Act permit the tax authority to set aside the actual transaction the parties entered into and price an alternative transaction where two conditions are met. First, it must be shown that the transaction “would not have been entered into between persons dealing at arm’s length.” Second, it must be shown that the transaction “can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.” Income Tax Act (Canada) ¶¶ 247(2)(b) and (d). This approach, which is an express override to generally applicable transfer pricing principles, protects the legitimate interests of the tax authority while protecting against a kind of free roaming inquiry into the business judgment of controlled party transactions.
aggressive transfer pricing conduct *provided* that sufficient skilled resources are directed to the effort.

We agree with the point made in ¶ 3 of Part II that “residual risks” that may generate BEPS “mainly relate to information asymmetries.” For that reason, we agree that an *ex post* pricing tool, carefully crafted, should be considered by the delegates (Option 1). The ability of taxpayers to leverage inside information by, for example, cherry-picking a portfolio to achieve BEPS results should be addressed. However, an *ex post* pricing mechanism must include safeguards to ensure that (i) it does not become a substitute for robust analysis *ex ante*; (ii) the taxpayer has an opportunity to demonstrate that it conducted such an analysis going into the transaction and that actual outcomes, if substantially different, either could not have been reasonably foreseen or were accounted for in a probability-weighted calculation of the return; and (iii) there are appropriate safe harbors or similar provisions to ensure that the mechanism is administrable within and across jurisdictions.

We also agree that solutions using CFC rules, as suggested in Option 5, merit further consideration by the delegates. The definition of “excess returns” would of course be a pressure point, but could include all income above an appropriate risk-adjusted return to the net capital investment of the CFC (inclusive of amounts invested in intangible and other assets).

We are extremely leery of Options 2 and 3, which make little sense to us for reasons addressed elsewhere in our comments. We simply do not understand the concept of “excess capital,” except possibly in the context of profit allocation under Article VII of the Model Treaty. As we have discussed, in extreme circumstances it may be appropriate for tax authorities to non-recognize a pure “cash box” structure, *i.e.*, where the entity does not have or exercise the capability to oversee risks managed by another, but in transactions characterized by good corporate governance practices, where the low-functioning entity has the capability to manage investment risk, normal transfer pricing approaches should be sufficient to address mis-pricing through, for example, overcompensation of the investor and under-compensation of the project manager.

Similarly, we counsel against heading down the “slippery slope” that would result from implementing Option 4. It would be very difficult to draw bright lines in this area that are not essentially arbitrary - we would prefer that the guidelines deal with “minimally functional entities” using traditional analysis of the controlled parties’ respective functions, assets and risks. All of these should be taken into account based on the facts and circumstances, and informed by market measures. There is no basis for elevating function (people) above capital when both are essential to the enterprise.

* * * *

The arm’s length standard based on separate entity accounting using marketplace benchmarks provides the best way to ensure that risk is properly compensated in a controlled group context. The marketplace captures risk pricing in every transaction, in countless and highly sophisticated and nuanced ways. Following this approach is relatively simple and produces reliable, verifiable results in most cases.

We do not defend the arm’s length standard and separate entity accounting because they satisfy some normative economic ideal, *e.g.*, assigning returns to parties commensurate with value creation. We don’t know if they do. But we return to our primary point – that tax administration is an intensely practical endeavor and transfer pricing is one of the areas that requires an especially practical approach. At bottom, our concern with the Discussion Draft is that it is impractical, seems
to import too much economic theory, requires adjustments without providing meaningful standards, and will lead to confusion and burdens for taxpayers and tax administrators alike.

Respectfully submitted,

Peter Barnes           Sean Foley   Matthew Frank                George Korenko
Mark Martin      Sam Maruca    Craig Sharon
Mr Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
OECD

By email: TransferPricing@oecd.org

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)

We thank you for the opportunity to make a submission in respect of the OECD work on transfer pricing and BEPS more generally.

Pitcher Partners is one of the largest accounting associations in Australia outside the Big Four and comprises 6 independent firms operating in Adelaide, Brisbane, Melbourne, Newcastle, Perth and Sydney. Our specialisation is advising smaller public companies, large family businesses and small to medium enterprises - which we refer to as the "middle market" or "SMEs" in this submission.

General comments

Clear guidance on Transfer Pricing (TP) is important to the middle market because ensuring compliance with TP rules in the current BEPS environment not only creates much uncertainty for smaller taxpayers but also imposes significant, and often disproportionate, compliance burdens on them.

Any rules that create further uncertainty and unpredictability for SME taxpayers about whether their actual arrangements may be subject to "non-recognition" or "re-characterisation" will exacerbate these existing compliance issues for SMEs.

We believe that further clarification is required to provide additional certainty to SMEs regarding the type of arrangements that may be subject to "non-recognition" or "re-characterisation" under the proposed changes to Chapter I of the TP Guidelines. In particular, better examples highlighting situations where each party is considered to have (or not to have) opportunities to enhance or protect their respective commercial or financial positions under an arrangement are needed.

Further, we believe that additional guidance on the role of contractual incentives (and disincentives) in abating or controlling moral hazard is crucial to better understanding the concepts of fundamental economic attributes of arrangements between unrelated parties and commercial rationality. This is because such contractual safeguards play a vital role in aligning the allocation of risk with the ability to manage or control exposure to risk in arrangements between unrelated parties.
Finally, we consider that the “Potential Special Measures” canvased by the Discussion Draft to deal with the BEPS problems posed by Minimal Functional Entities (MNFs) are not only unnecessary (given the proposed changes to Chapter I of the TP Guidelines) but will be extremely problematic to implement and apply consistently. As a result, they are likely to be burdensome for taxpayers (particularly SME taxpayers) and tax administrators alike.

**Detailed comments**

For ease of reading we have set out our detailed comments in an Appendix and made reference to the particular paragraphs in, and options canvased by, the Discussion Draft where relevant.

Please contact the writer on +61 3 8610 5401 if you would like more information on, or clarification of, any of the issues raised in this submission.

Yours faithfully
PITCHER PARTNERS ADVISORS PROPRIETARY LIMITED

DENISE HONEY
Executive Director

Encl: Appendices
APPENDIX

Part I – proposed revisions to Chapter I of the TP Guidelines
Comments on the example at draft paragraphs 90 and 91 regarding the concept of fundamental economic attributes of arrangements between unrelated parties

The example at paragraphs 90 and 91 involves the sale and lease-back (by way of licensing arrangement) of a valuable trademark developed by Company S1.¹

In our view, the trademark sale and lease-back arrangement used in the example lacks commercial rationality. This is because trademarks derive their value from the reputation of the business which uses those trademarks in the course of selling its products or services. A trademark without any underlying reputation/associated market perceptions cannot be exploited for business purposes (e.g. revenue generation).

Therefore, once a trademark has been used by an entity in conducting its business in a particular market (thereby establishing the association between the reputation of the business in that market and the trademark), and that entity intends to continue conducting its business in that particular market using the same trademark, it would not be commercially rational behaviour for that entity to surrender (or be otherwise constrained in using) the right to continue using that trademark in conducting its business in those markets.²

Since the purpose of the example is to illustrate a lack of fundamental economic attributes of arrangements between unrelated parties by reference to the lack of opportunities for each party to enhance or protect their respective commercial or financial positions, we suggest that a better example would be one involving a commercial intangible (such as a patent or know-how).

This is because we consider that arrangements involving the sale and leaseback of, for example, a patent, may prima facie seem commercially rational prior to any consideration of whether or not there are opportunities of each party to enhance or protect their respective commercial or financial positions under the arrangement.

We would welcome further guidance from the OECD in the form of multiple examples using similar types of commercial intangibles.

Part II – Potential Special Measures
General comments

As noted above, we consider that the “Potential Special Measures” canvased by the Discussion Draft to deal with the BEPS problems posed by Minimal Functional Entities (MFEs) are unnecessary (given the proposed changes to Chapter I of the TP Guidelines), and that the associated compliance costs would be overly burdensome for taxpayers, especially SME taxpayers, and tax administrators alike.

Further, the arm’s length principle reflects the economic realities of the each taxpayer’s particular facts and circumstances and utilises the normal operation of the market as a reference point. Any departure from the arm’s length standard would represent a shift away from the international consensus, founded upon fundamental economic principles and

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¹ In the example, Company S1 sells its rights in a marketing intangible (a trademark) which it owns, has developed, uses and intends to continue using in conducting its business.

² It is acknowledged that an entity would be willing to enter into a license agreement whereby it licenses the rights to use and/or sublicense its trademark in markets where it is not already being used.
commercial realities, with the effect of imposing disproportional and overly burdensome compliance costs on SMEs in particular.

Notwithstanding the above, if “Potential Special Measures” are considered necessary, then we believe that providing certainty around the operation of such measures and minimising the associated compliance costs, particularly for SMEs, should be principal considerations.

Comments on Option 4

In our view, the adoption of a targeted special measure that focuses MFEs and seeks to reallocate the profits of such entities amongst other group entities (i.e. Option 4) would be extremely problematic to implement and apply consistently for the same reasons stated at paragraphs 1.22 to 1.31 of the Guidelines for rejecting formulary apportionment.

As noted above, we consider that the proposed revisions to Chapter I of the Guidelines (in proposed section D.2 through D.4) go far enough in limiting the potential for BEPS involving MFEs by having regard to the actual conduct of entities and applying the commercial rationality test. As such, we consider it would be unnecessary and overly burdensome to have a targeted special measure, outside of the arm’s length principle, focused on dealing with the BEPS problems posed by MNFs.

If any targeted special measures (outside the arm’s length principle) are to be considered for dealing with MFEs, then we consider that it would be better practice to target such arrangements by cancelling/eliminating any tax benefits/savings arising in entities as a result their commercial or financial arrangements with entities resident in low or no tax jurisdictions (e.g. through denying deductions or imposing punitive withholding taxes).

Comments on Option 5

While we are generally supportive of robust CFC rules (and indeed consider many aspects of Australia’s CFC rules to be in keeping with best practice globally), similar to the MFE measure canvased at Option 4, we consider that the so-called “secondary rule” proposed at Option 5 would be not be viable for the same reasons stated at paragraphs 1.22 to 1.31 of the Guidelines for rejecting formulary apportionment.
February 5, 2015

Sent Via Email: TransferPricing@oecd.org

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

Written Comments on the Revised Discussion Draft
Chapter 1, Risk, Recharacterization and Special Measures
The OECD
Paris, France

Re: Risk, Recharacterization and Special Measures Comments

These comments are made by Shaun T. MacIsaac, Q.C., on behalf of the law firm of Pittman MacIsaac & Roy (“PMR Law”), Calgary, Alberta, Canada, with respect to the Revised Discussion Draft (the “RDD”) on Risk, Recharacterization and Special Measures dated December 19, 2014.

This law firm advises multiple clients on transfer pricing disputes and is presenting current cases before the Tax Court of Canada. The firm has been counsel in past legal cases, including the leading decision in AP Circuits v The Queen, 2011 TCC 232, 2011 DTC 1177.

The RDD proposes new commentary regarding risk and recharacterization, and special measures. This presentation will address itself to the issues on page 14 of the RDD regarding risk and recharacterization.

In summary, our firm’s opinion is that:

A. Risk. The increased emphasis on the impact of risk and the added guidance on which party to a controlled transaction has the ability to control the risk is useful, and will further improve the ability of taxpayers to price transactions.

B. Recharacterization. The suggested broader scope for non-recognition in cases where there is a lack of “commercial rationality” and where “the structure adopted … impedes a transfer price” (quotes from paragraph 88 of the RDD) leads transfer pricing into an area where both the nature of the transaction and the pricing of the transaction are in dispute. This dual analysis widens and complicates the issues under discussion, and thus creates more disputes. Any transaction ought to be capable of being
priced for transfer pricing purposes, unless it is a sham, or parties are not acting in accordance with their contractual agreements. The guidance should direct itself to look critically at the value of the contributions of the parties to a controlled transaction, and not the nature of the transaction, as the basis for a transfer pricing entitlement.

These comments will direct themselves to answering seven of the eight questions on pages 14 and 15 of the RDD.

1. Introducing The Concept Of Moral Hazard

Question: 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?

Opinion

In our opinion, moral hazard is a reasonably straightforward concept that can be dealt with by stating that when analyzing risks assumed, it is important to consider not only the terms of a controlled transaction, but also to investigate the degree of control over risk actually exercised by each of the controlled parties to a transaction to arrive at a proper transfer pricing result. This has been expressed very well, especially in paragraphs 48 and 49 of the RDD that express the value of the impact of risk, and is developed in the examples in paragraphs 51 to 53 of the RDD. As many new concepts have recently been introduced by the OECD, such as the “intangible related return” and “aligning transfer pricing outcomes with value creation”, a new label called “moral hazard” to attach to the importance over the degree of control and impact of risks is not necessary, and will result in still more differences of opinion and disputes. The important step is to have identified in the guidance the degree of control over risks and the impact of risks assumed, which has been well done.

Analysis

The concept of moral hazard is defined on page 14 of the discussion draft to mean the “... lack of incentive to guard against risk when protected from its consequences.” The context suggests that related parties tend not to define financial rewards and specify contractual terms to align the ability to control risk with the degree of control in a controlled transaction. The consequence of this failure is that in a transfer pricing context, the analysis of risk ought to go beyond the terms of written agreements and attach financial reward to the party to the controlled transaction that has the capacity to bear the risks.

Using the example in paragraph 63 of the discussion draft, which is that of a subsidiary company that owns a piece of equipment, and a parent company that provides specifications for the use of the equipment,
operates the equipment, provides personnel and markets the equipment, then it is clear that while one party has ownership of an asset, the other party has effective control over whether the parties will succeed in the commercial exploitation of the asset. From the point of view of risks assumed, the parent company should then be entitled to a reward for transfer pricing purposes for its control over risks assumed.

The 2010 Revision of Chapters I-III of the transfer pricing guidelines, Chapter 3, states that an analysis of risks assumed is part of a comparability analysis, which in turn, is part of the nine-step process outlined in paragraph 3.4 thereof. The commentary in Chapter 1 should be amended as proposed to add provisions that increase the importance of control over risk and clarify the impact of risk.

2. **Core Competencies**

**Question:** 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?

**Opinion**

The Guidance should simply note the tendency of taxpayers and unrelated parties to want to protect their intellectual property and intangibles of all kinds from disclosure. Caution must be applied to an analysis of intangibles as the complete facts are not easily determined, but are needed to perform a proper analysis. All parties need to be aware that there is often incomplete information, disclosure and understanding that is justified by the natural tendency of businesses to protect confidential information.

**Analysis**

This question addresses the difficulties in obtaining from unrelated parties complete insights about core competencies, and obtaining from controlled transactions complete information related to intangibles.

This is certainly an issue when trying to investigate a controlled transaction, as multi-national enterprises (“MNE”) are willing to share intellectual property and market opportunities with controlled entities in ways that would be unlikely between arm’s length companies. In this way, MNEs facilitate the sharing and exploitation of intellectual property to on a wider scale, but also make the challenges of transfer pricing more difficult.

There is no formula or insight that resolves the challenges posed by the fact that controlled transactions are unique, and often cannot easily be compared to uncontrolled transactions.
Transactions are often unique to a controlled party, which means that the transfer pricing analysis of the value drivers of many transactions often are difficult to price by the use of comparables. For this reason, transactions have to be carefully analyzed, and risks assumed are one of many factors that need to be considered.

3. Moral Hazard and Non-recognition of Transactions

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

**Opinion**

Any transaction that is the subject of an agreement should be capable of being priced, and should not be the subject of non-recognition. The only exception should be for a sham, which is when the parties to a controlled transaction do not follow their written agreement. Transfer pricing should be about pricing transactions. There is no underlying tax principle worthy of protection that justifies non-recognition of agreements. In the paragraph 90 example, the only issue should be whether the $400 Million paid is enough, and later whether the royalty is properly priced, and not whether a trademark can be transferred to a low tax jurisdiction.

**Analysis**

This question brings the issue of moral hazard into the context of determining whether a transaction should not be recognized for transfer pricing purposes. It is difficult to understand the relationship between moral hazard and non-recognition of agreements, but the explanation offered in the guidance at paragraph 88 of the RDD is that even though it is acknowledged that commercial agreements between controlled parties do not have terms that would exist in other contracts, the test is a two-legged one, based on “commercial rationality” and whether “the structure adopted … impedes a transfer price”. Paragraph 90 of the RDD considers an example where a trademark is transferred to a low tax jurisdiction. The example then tells us that the low tax jurisdiction affiliated is functionally challenged, so that all it does is own the asset. The example tells us that the transaction should be ignored in that situation so that the trademark is still left in the jurisdiction that transferred it. The rationale is that a commercially rational businessman acting reasonably would not have transferred its trademark for the price paid or for any price.

In this respect, the example raises fairly the question of the direction of the guidelines when it relates to non-recognition of commercial agreements. If the policies of the OECD are to promote trade, avoid double taxation and provide clear guidance, then the power to say that a transaction should not be recognized should only be used where the parties do not follow the agreements that they have in place. Where they do, notwithstanding the comments in paragraph 88 of the RDD relating to pricing a transaction not being enough
in some circumstances, the real issue in cases such as example 90 should only be whether the transaction is properly priced.

4. Transactions that shift risk

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

**Opinion**

To the extent that shifting risk can be isolated as the only purpose for a transaction, then the transfer pricing issue should be to properly reward the party that has control over the risk obligation.

**Analysis**

Transactions that have the sole effect of shifting risk are unusual in the sense that most transactions have a business purpose, and thus the real issue in practice is to consider risk amongst a number of other features of a transaction, and give its proper weight. One wonders how often this type of transaction arises in practice.

5. How does transfer of trade mark change risk analysis

**Question:** 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?

**Opinion**

The challenge of dealing with high tax jurisdictions and low tax jurisdictions should not be conflated with the issue of proper pricing. Having paid $400 Million dollars, the low tax jurisdiction party ought to have received an asset of that value for all purposes, including transfer pricing. Generally, a successful transfer pricing policy ought to ensure that countries can protect economic activity in their jurisdiction, and nothing more. In this case, as ownership was sold, the issue should be the value used in the sale transaction, and the value of the ongoing royalty payment.

**Analysis**

The example in paragraph 90 does present divergent views on transfer pricing. In the example, a valuable trade mark is transferred for $400 Million dollars from one high tax jurisdiction to a low tax jurisdiction. The
policy issue is whether transfer pricing should seek to arrive at an arm’s length price for the transaction, or should there be rules that disregard the transaction.

If an MNE transfers an asset for fair market value, the transaction ought not to be challenged. Once the asset is owned by a low tax jurisdiction controlled party, then the analysis should be as to whether or not payments such as royalties reflect an arm’s length price. While the proposed guidance suggests a widening of the group of transactions that should not be recognized, we disagree with this in principle on the basis that the objective of transfer pricing should be to properly price transactions.

To those that argue that these transactions result in BEPS, we say that the jurisdiction that sold the valuable trademark received value which it is entitled to tax as profit. The unfairness of non-recognition is that it results in double taxation, a result that is objectionable on a principled basis.

6. What is the importance of risk return to transfer of trademark

Question: 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?

Opinion

For transfer pricing purposes, the existing comparability analysis of companies operating in a similar business should be enough to be able to deal with these challenges. The fact that, in controlled transactions, parties fail to identify risks that will be controlled by one or the other party simply means that the factual issues are complex. The guidance should be useful in noting that the identification of risk should include an analysis of the contracts, and the underlying performance of the obligations to determine the conduct of the parties, and the control over the risks. All need to be considered and balanced in a reasonable fashion.

Analysis

Risk return is a concept that simply notes that the higher the risk taken, the higher the expected profit should be. The rationale is quite simple: a reasonable businessman will take more risks if a greater reward is possible, and fewer risks if a smaller reward can be obtained.

This concept is also straightforward in the sense that it is part of the identification of the transaction between the controlled party and its related party. For instance, in drilling oil wells, there are the risks of the well blowing up, but also the risks of not finding hydrocarbons. In order to induce a party to participate in a transaction, high rewards must be available.
7. Does risk return relate to transfer of risk

**Question:** 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?

**Opinion**

In the two questions set forth above, the threshold issue is the absence of an understandable definition of the concept of commercial rationality. The additional problem is that the guidance is equally unclear as to what the consequences are of non-recognition, while noting in paragraph 84 of the RDD that double taxation will occur. We recommend that the transaction be considered as it exists, and that transfer pricing principles assign weight and value to relevant terms and conditions of agreements, and to other economic circumstances, including control over risk. Then the only remaining challenge is to price the actual transaction. All of the tax policy considerations that result from deciding when to apply non-recognition are simply avoided by fairly pricing what was done. This solution may seem simplistic, but it is much more likely to be accepted by the countries of the world as a whole, and by compliant taxpayers that seek clarity and understandable rules for transfers of intangibles. A cornerstone of world trade is that any asset ought to be capable of being transferred in an open market.

**Analysis**

The first part of the question provides an example that shows the risk-return trade-off can be applied opportunistically by the manipulation of discount rates to prove that a transaction is economically rational. The second part of the question raises the question of whether the solution to the problem lies within or outside the arm’s length principle.

The assumption behind both questions is that it is proper policy to attack a transaction as not being commercially rational. While this is part of the non-recognition analysis guidance in proposed paragraph 88 of the RDD, this problem really arises from the desire to recharacterize. Transactions that are a sham have been recognized by the courts as such, where parties do not act in accordance with their contractual
agreements. No other policy argument but a sham or a failure to follow an agreement justifies the extreme remedy of recharacterization. An approach that would allow contractual terms that conflict with legitimate expectations to be given less weight, according to useful guidance is the preferred direction. In the law of contracts generally, courts of the world distinguish amongst:

conditions that are fundamental to a contract;
terms and warranties that are significant, but when breached do not invalidate the contract; and
mere puffery, which are statements that are not contractually significant.

It is unfortunate that non-recognition seeks to invalidate contracts, when a much simpler process would be to disregard certain terms of a contract when they conflict with principles such as control over risk. In this way, weight could be given to contractual terms on a principled basis.

**BEPS Initiative Policies Regarding Risk and Recharacterization.**

The BEPS initiative does seek to avoid base erosion. The best defence against base erosion is a clear understandable set of rules that provide guidance that is easily applied.

The fundamental challenge posed by non-recognition is that the tax payer is left with double taxation as the penalty for engaging in international commerce. While some may not approve of low tax jurisdictions, double taxation is an even greater impediment to world trade. The area of compromise is to apply rigour and principled vigilance in scrutinizing controlled transactions between high tax and low tax jurisdictions.

Yours truly,
PITTMAN MacISAAC & ROY

“Originally signed by”

SHAUN T. MacISAAC, Q.C.
February 5, 2015

Dear Mr. Hickman:

OECD Public Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization, and Special Measures)

We thank you for providing Praxity, AISBL\(^1\) with the opportunity to comment on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization, and Special Measures). In an effort to reduce review efforts for OECD, we have compiled responses from several Praxity member firms; information about the contributors and cooperating firms is included in this letter.

We welcome OECD’s efforts to create a set of measures to prevent abuse through transferring risks among group members, as discussed in the Draft. What follows are our general thoughts on measures suggested in the draft, as well as answers to some of specific questions raised in the Discussion Draft.

On Behalf of Praxity,

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RESPONSE TO OECD DISCUSSION DRAFT ON REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERIZATION, AND SPECIAL MEASURES) “Discussion Draft”

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General Comments

We appreciate the continuing work and efforts of the OECD, the Committee on Fiscal Affairs and its working groups related to revision of the existing and introduction of new transfer pricing rules that aim at combating base erosion and profit shifting. We recognize the importance of the goals of this work and the underlying logic of the suggested modifications and amendments. At the same time, we would like to express several concerns related to the impact of the suggested measures on our clients in small and medium enterprises (SME) sector and offer our thoughts in this regard. What follows are our general comments on the matter, as well as answers to certain specific questions raised in the Discussion Draft.

We would like to express several fundamental concerns with the proposed revisions that may inadvertently affect bona fide taxpayers in their dealings with group members.

Disregard of the value of a contractual arrangement between parties

From our reading of the Discussion Draft, there appears to be an overall presumption that permeates throughout the Discussion Draft that multinational taxpayers are presumed to be non-compliant with the transfer pricing rules and are consciously structuring their intercompany dealings to evade paying taxes. The Discussion Draft intimates that arrangements between group members are not to be relied
upon prima facie. Specifically, it is pointed out in the Discussion Draft that “it should not be automatically assumed that that the contract accurately and comprehensively captures the actual commercial or financial relations between the parties.”

First, it should not be the goal of the OECD to disregard bona fide contractual relationships between taxpayers that are members of a multinational group. Contractual arrangements are put in place by parties as a tool to manage liability and risks, hence a departure from contractual terms cannot be explained solely by tax planning motives. The Discussion Draft seems to intimate that even a slight departure or deviation from the terms of the contractual arrangement casts the entire arrangement into doubt and a recharacterization of the arrangement by the relevant tax authority could be the logical outcome. Second, Praxity member firms as practitioners as well as its SME clients are concerned that such a negative premise will open the door for protracted investigations and arbitrary adjustments by local tax authorities. As such, local tax authorities would appear to have the ability to pick and choose which contractual terms can be deemed to be invalid and/or completely disregard contractual framework of any relationship. Finally, jurisdictional (local) tax authorities may interpret contractual relationships between the parties in their own unique way and initiate their own adjustments without regard to the position of other affected local tax authorities that may be concurrently proposing an adjustment in a different jurisdiction.

It can also be argued that such downgrading of the value of a contract may have an unintended consequence of the parties intentionally bypassing concluding intercompany contracts altogether or defining the terms of their contracts in an overly obscure or vague manner. This would depart from the standard practice of taxing authorities in certain jurisdictions, particularly in the U.S., where the starting point of assessing an intercompany arrangement by a tax authority is based upon an evaluation of the contractual terms and conditions contained within the agreements. As such, it is recommended that guidance be provided that if there are deviations from the contract in place between the related parties and their actual conduct, which does not have a material effect on the prices between the parties, that a recharacterization of the arrangement should not be the logical conclusion by the tax authority. It must be noted that in arm’s length dealings between related parties, the parties often deviate from terms of the agreement, which may or may not have an impact on the pricing outlined in the contract.

**Need for a Strong and Enforceable Dispute Resolution Mechanism**

It is paramount that the efforts made to revise the Guidelines go hand in hand with the improvement of the dispute resolution procedures to ensure an accessible mechanism for efficient cooperation between taxing authorities in different countries. Without the checks and balances of an accessible dispute resolution procedure, a strong commitment by countries to agree to those procedures, and assurance that the decisions will be enforceable – the goals of the revisions to Guidelines and many other BEPS actions are not likely to be achieved without detriment to bona fide taxpayers. Since SMEs do not, by definition, have the resources of the large multinational corporations, having an accessible mechanism with a high likelihood that the results will be consistent across countries is very important.

Failure to adopt such a mechanism will allow taxing authorities to take unilateral actions in the name of BEPS. These unilateral actions will create substantial uncertainty and result in higher compliance costs for bona fide taxpayers without increasing compliance or otherwise adding value. This result
cannot be seen consistent with the goals of BEPS and will effectively impose double taxation on bona fide taxpayers.

**Specific Concerns of Small and Medium-Sized Enterprises**

We would like to stress the practical importance of safe harbors and bright line rules in the context of transfer pricing arrangements for SMEs, which are the majority of the clients Praxity represents. Often times, and in contrast to large MNEs, SMEs are especially sensitive to uncertainty, for they do not typically have sophisticated intra-group tax structuring in place, nor do they have a lot of resources and capacity to spare on resolving dispute resolution matters or in the preparation of extensive transfer pricing documentation. As written, SMEs would face an excessive compliance burden with regard to complying with the tenets of the Discussion Draft. For instance, in the context of risk assessment, the extensive documenting, identifying and analyzing all risks may not be feasible in many situations for SMEs. This is pertinent because a comparison between how a SME allocates the risks between its parties and the allocation of risks in a comparable uncontrolled arrangement is often not possible (i.e., information of the comparables assumption of various risks is often not available). Nonetheless, the current version of the OECD Guidelines does not relax compliance or the level of scrutiny for SMEs through implementation of safe harbors and similar techniques. Additionally, in the absence of safe harbor rules in OECD Guidelines local authorities may be tempted to wipe out existing safe harbors or similar mechanisms.

**Huge Emphasis on Risk as opposed to Functions of the Group Members in the Discussion Draft**

We believe that the analysis of the functionality of group members should be granted precedence and weight over the analysis of the allocation of risk, for the following reasons: (1) risks are harder to identify as opposed to functions of a group member; (2) the impact of a particular risk is not easily quantifiable; and (3) it is challenging in practice to determine comparables in the context of risk analysis.

**Interaction between Discussion Draft and Other BEPS Action Items**

The overall impact of the revisions to the OECD Guidelines per the Discussion Draft cannot be appropriately assessed by tax practitioners and SMEs without analyzing its interplay with the other measures proposed within the BEPS initiative, e.g. interest deduction rules or permanent establishment issues. Consequently, in our opinion, the most reasonable overall approach to implementation of the revisions to OECD Guidelines and related rules is to withhold finalization of separate drafts until the full scope of the BEPS rules implementation is clear.

**Specific Answers**

Below herein we address specific questions raised in the Discussion Draft:

**Re: 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?
In our view, moral hazard should not be regarded as a highly important factor in the context of risk analysis, for the reasons discussed below. The Discussion Draft emphasizes the connection between risk and management/control of an entity. In particular: “between the parties, the assumption of risk without the control exerted by management over the risk is likely to be problematic.” The above interdependence of risk and management/control is explained firstly, by difficulties in measuring a return for the party assuming the risk with no control over it; and secondly, by a moral hazard, i.e., reluctance of a party to assume risk with no control over it.

Perhaps, the interdependence of risk and management is overstated in this approach. For instance, the good faith principle that generally is applied to arm’s length contractual and business relationships is ignored. In practice, however, counterparties do not usually act as adversaries and may be willing to part with control due to various considerations, such as market entry difficulties, field of expertise constraints, etc. It is typical, in a third party contractual arrangement, that risks are often transferred to another party where the transferor no longer has the ability to manage those risks. Any inclusion of the concept of moral hazard should be limited to a minor aspect of comparability assessment and the weight of which should not be a major determinant in how the arrangement is assessed and analyzed. Moreover, the concept of moral hazard is not easily quantifiable.

Additionally, the analysis of the risk as presented in various sections of the Discussion Draft ignores the risk associated with participation of other stakeholders in the business, such as shareholders of a corporation, that do not necessarily have access to management/control over separate transactions. It seems that more regard should be given to this issue, especially as it concerns special measures in Part II that go beyond the arm’s length principle.

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 our view, this statement does not necessarily reflect the real life relationships between contracting third parties, as independent parties often share industry insights and intellectual property amongst each other for their own benefit. It is not unusual for independent companies to share a piece of its own intellectual property or know-how at no additional cost to a third party with the expectation that the intellectual property adoption by a third party will generate a greater economic benefit in the future (i.e. greater market share) for the intellectual property owner compared to the case of not sharing and/or charging a royalty for the piece of intellectual property. For example, in electric car market, Telsa, a leading electric car manufacturers, is willing to share its proprietary fast-changing technology to third parties to promote its own plug-in electric cars in an effort to gain greater market share and market dominance against other competitors such as BMW or Nissan. An extension of this might be found in the Prisoner’s Dilemma, from classical game theory, where unrelated parties can work together to mutually benefit and derive great utility by coordinating their efforts than through taking a singular or myopic approach.

Another example where third parties are willing to share proprietary insights is seen in independent alliances, such as Praxity itself. Even though member firms provide accounting and tax services and are in essence competitors, they often share new ideas and consult on interpretation of legal aspects that affect clients. Member firms may even join together to provide a consolidated view on certain
topics related to their practice or business operations, with the intent of promoting its own firm as well as creating benefit to the industry as a whole.

**Re: 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?

Transactions that involve the transfer of risk between associated enterprises are common occurrences. Examples include captive insurance companies and distribution entities (both limited risk and commissioner arrangements). In these examples, risk must be valued using actuarial principals (captive insurance companies) or through the use of comparable companies (distribution entities).

Captive Insurance Companies (“CICs”) involve the use of a specialized, regulated entity that handles only the risks of related operating companies. As with any insurance product, companies shift risk related to its operations. Some insurance coverages are predictable and can be estimated with a high degree of predictability (health insurance and workers compensation claims). Other insurance coverages for low frequency, high exposure claims are able to be calculated with some accuracy over several companies, but difficult to accurately calculate for one company or for a few companies. For example, prior to 9/11 very few businesses insured for terrorist exposures. Now, many companies have insurance for risks related to terrorism, but the odds of a significant event is very low for one company. The industry’s answer to quantifying the risks for CICs is to calculate higher premiums in the early years that start to decline after reserves are built up in the CIC over time.

We suspect that the OECD may view the higher estimate of costs in the early years to be an action associated with tax evasion while it is an industry standard that is very prudent from the CIC point of view. The CIC would, in many cases, be wiped out if a high exposure (although low frequency) event happened early in its formation.

Another example would be that of a dealer that sells and services a particular manufactured product. In this case, the business arrangement could be that the dealer will assume some of the risk of defective product. The manufacturer has reputational risk and is generally expected to manufacture quality products. Initially, the dealer will negotiate and agree to a compensation based on expected defective product risk. However, if the dealer experiences significant quality issues, then the dealer will learn from the experience and seek to adjust the compensation according to the risk as it materializes. Going forward, the dealer may negotiate and require the manufacturer to bear certain servicing costs or all costs beyond a certain threshold or recall and replace products. The dealer may also revise the terms and decide to sell and service products without bearing the risk of defective products by requiring the manufacturer to bear all of these costs. Another extreme would be that if the dealer experiences that the manufacturer does not cooperate with product recalls or replacing defective parts, the dealer may make the business decision to discontinue selling the product from this manufacturer. In all of these scenarios, the initial compensation is estimated based on “expectations” and the compensation going forward is adjusted based on “expectations as well as past experience.” Generally, there is a time lag and experience gap between the realization of risk
and the adjustment of compensation. It any case, it is common to see that any compensation generally results into a different actual profit or loss than that budgeted even among unrelated entities. Therefore, it may be unfair to penalize associated enterprises simply for this reason by imputing that intercompany arrangements are intentionally designed with tax evasion in mind.

Additionally, the use of limited risk or commissionaire arrangements is a common practice for most multinational manufacturers. Forming sales entities in its global markets is prudent in that it allows a local entity familiar with the local markets and assists with isolating sales and profits in the countries to help them meet expectations of local taxing authorities. It also helps U.S. companies, in particular, meet certain anti-deferral rules when products may flow through regional, rather than country, sales entities. The allocation of risks between the manufacturer and limited risk or commissionaire entities must be based – as you stated in the Action Items – on the actual functions performed in the entities. However, where certain risks are arbitrary, legally enforceable documentation can shift product liability and warranty exposures to the (often) deeper-pocketed manufacturing entities.

While we understand the OECD’s innate suspicion that contracts whose sole purpose is to transfer risk should be scrutinized, that innate suspicion comes through too strongly. While risks are difficult to quantify, if two associated enterprises have a legally enforceable contract involving only risk, the contract should be valued using actuarial principals (for insurance or similar contracts) or using comparables when available. In the case of CICs the initial premiums may seem high or otherwise disproportionate, but may be prudent from the CIC perspective. The business purpose of both associated enterprises must be considered and balanced over time.

**Re: Special Measures**

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

In a third party situation, unrelated parties do not renegotiate the terms of an arm’s length transaction where the payment was in the form of a lump sum in the case when one of the parties realizes, several years later, that their forecast was not accurate at the time they were evaluating entering into the arrangement. However, we recognize that related parties may be tempted to intentionally create forecasts that would have a beneficial impact on the value of the transfer and so there is a need to have safeguard against such a situation. This ex-ante requirement to review the value of the intercompany transfer should be balanced against the level of compliance and resources, especially for SMEs. The OECD, in its revision, should review the commensurate with income standard as outlined in Internal Revenue §482 for guidance with this concept.

Generally, the suggested measure may be seen as a reasonable method to determine the taxable value of an intangible ex post. At the same time, the following should be pointed out:

1. In practice thresholds could be established with respect to the valuation process. Care should be exercised when dealing with such requirements for evaluations or possible subsequent re-evaluations (adjustments to initial valuation), so that the implementation of the said rules does not lead to constant need for re-adjustments.
2. In the spirit of fairness in relationships between taxpayers and tax authorities, the question should be addressed on how to deal with decreases in value and losses related to hard-to-
value intangibles. It is our opinion that downward adjustments should be permitted where upward adjustments are allowed, at the very least, to the extent of prior inclusions in income.

**Option 3: Thick capitalization**

The adoption of thick capitalization in addition to thin capitalization rules, would seem to be administratively difficult and imprudent. Thin capitalization rules provide countries with the ability to balance outlays from a local company to its parent between tax favored interest expense payments and less favored dividend payments. Thick capitalization would, conceivably, do the opposite and would impose artificial debt requirements on local companies.

The U.S. tried to impose bona fide debt regulations in the early 1980s (Internal Revenue Code/IRC § 385) with the goal of defining what interest expense was *bona fide* and what interest was *faux* capital. The IRS withdrew its Regulations within three years of their introduction. The concept of Thick Capitalization seems to be getting at this same concept. The U.S. was never able to finalize IRC § 385 due to public dissent on how it would or could be administered. The U.S. relies upon a more flexible court system that considers up to twenty-four different factors when it determines what is *bona fide* debt or not. The U.S. Supreme Court has described the debt vs equity as “vexing” (Pullman-Standard vs Swint 456 US 273, 288 (1982)) and “difficult” (Cooter & Gell vs Hartmarx Corp, 496 US 384, 401 (1990)).

For such a regime to be effective and fair, it would have to be flexible with regard to industry norms and with regard to the global structure of the company as a start. Work in, as appropriate, the other twenty-six factors that U.S. courts regularly apply to determining what *bona fide* debt is and you may have a workable definition of thick capitalization. However, we have greater confidence that a court can administer such rules more appropriately than taxing authorities with the same guidance. The U.S. Congress apparently agrees, also.

**Option 4: Minimal functional entity**

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.*

In many instances, companies in a third party context outsource the majority of their functions to third parties. This is especially acute in the technology industry where development, sales, administrative and even management functions are outsourced. Moreover, the strategy of coordinating a mass-assemblage of talent, capital and assets is in fact a strategy often used in many industries, including Pharma. The value enhancing activities is the fact that one can create a coordinated approach to solving a myriad of issues by leveraging the experience and resources of other parties (either related or unrelated) to exploit a niche in the market and generate economic profits. This is not unlike the professional sports coach, who alone does not have the athletic prowess to play the sport, but instead has the wherewithal to pool talent and resources to compete at a national level. Thus, the notion that a related party outsourcing the majority of its functions should not condemn its intercompany arrangement to be classified as solely tax motivated.
Quantitative Measures: *The company in substance performs mainly routine functions, has a small number of employees; a substantial part of the company’s income is from arrangements with group companies; and 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 determining factors to assess if a particular intercompany arrangement should be respected seems to suggest there should be a predefined number of employees associated with an entity that performs a specific function or it cannot have significant dealings with related parties. This concept ignores basic business principles exhibited in successful businesses such as 1) being efficient with few employees, which could suggest the existence of process know-how, or 2) third parties that outsource many activities to third parties (such as technology companies which outsource manufacturing, sales, implementation and administrative functions).

Overall, this option appears to be a significant departure from the arm’s length standard and appears to promulgate formulary apportionment by the OECD and provide the tax authorities with the unfettered ability to reallocate profits using formulary apportionment or even arbitrary apportionment methods. Option 4 should be removed from any further consideration.
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PwC's Comments 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

PricewaterhouseCoopers LLP (“PwC”), on behalf of its international network of member firms, welcomes the opportunity to comment on the OECD BEPS Actions 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 (“Discussion Draft”). As a global professional services business with a network of firms throughout the world, we have worked with tax authorities around the world over many years regarding the development of transfer pricing rules that affect multinational entities (“MNEs”) in their cross-border transactions. As a result, we have extensive experience with the wide range of issues relevant to both taxpayers and tax authorities.

General Comments on Discussion Draft

Given the complexity of the subject and the difficult issues the OECD is attempting to address in the Discussion Draft, it is useful to set forth an overview of some concerns we wish to be addressed that are necessary to preserve some fundamental tenets of transfer pricing and the arm’s length principle:

- We note that other portions of the existing OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“Transfer Pricing Guidelines”) (e.g., Chapter VI addressing Intangibles and Chapter IX addressing Business Restructurings) already provide a reliable framework to ensure the sanctity of the arm’s length principle in the context of risk characterization and allocation. In addition, many domestic tax regimes have robust anti-abuse rules and the capacity to enact legislation to recharacterise transactions where the economic substance of a transaction differs from its form. In this regard, PwC believes it is most productive to adhere to the existing framework that has been vetted among OECD countries and generally accepted as preserving the arm’s length principle. Furthermore, not taking into consideration relevant law and regulations already in place would lead to confusion and uncertainty for tax authorities as well as taxpayers as they try to reconcile the potentially inconsistent guidance prescribed by the Discussion Draft with rules already enacted or promulgated under domestic tax regimes.

- The arm’s length standard is meant to provide broad parity of tax treatment for members of MNE groups and independent enterprises. By placing associated and independent enterprises on a more equal footing for tax purposes, the arm’s length standard avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. We are concerned that the Discussion Draft deviates significantly from the arm’s length standard, and that many of the provisions of the Discussion Draft suggesting legal
agreements as a mere starting point to reconcile perceived conduct by the parties to a cross-border transaction may cause significant uncertainty with regard to the application of the arm's length standard. The OECD has put a great deal of effort into establishing the arm's length principle as a near-worldwide standard for determining the pricing of transactions between associated enterprises. As a result, most tax regimes have followed suit and incorporated the arm's length principle as the cornerstone of domestic transfer pricing regulations. Establishing that common framework has been a great boon to economic growth, as it minimizes the disputes and double taxation that can hinder cross-border trade and investment. It has also helped to satisfy taxpayers’ need for certainty with respect to how cross-border transactions will be treated by various tax authorities. We are concerned that the proposals in the Discussion Draft unnecessarily jeopardize that consensus. Several proposals in the Discussion Draft seem to be designed simply to enable tax authorities to more easily disregard contractual allocations of risk, to recharacterise legitimate business transactions, and to utilize special pricing measures inconsistent with the arm's length principle. Implementing such proposals would, therefore, contradict existing domestic tax laws, causing confusion as to how the new Guidelines should be implemented in the context of countries’ existing legal frameworks. PwC believes the objective of the Discussion Draft should be to improve upon the arm’s length principle and provide better pricing of transfers of risk among related parties.

- The revisions to the Discussion Draft should consider how other aspects of the Action Plan will impact MNEs and the issues that the OECD is addressing in the BEPS project. We recommend that the OECD view the revisions to the Discussion Draft in the context of the BEPS action plan as a whole. Also, it may be the case that other workstreams address transfer pricing issues sufficiently such that the arm's length principle does not need to be radically altered.

- PwC reiterates that the Transfer Pricing Guidelines already address risk and recharacterisation. Providing guidance that may not be consistent with the arm’s length principle would be a significant modification to the Transfer Pricing Guidelines. In addition, the Discussion Draft, in its current form, places a heavy burden on domestic tax authorities to determine what is commercially reasonable instead of providing clear instructions on how to analyse related party business transactions and structures. Any changes should be recommended only after considerable deliberation and consideration, and only on a consensus basis.

- PwC recommends the revisions to the Discussion Draft focus on providing objective advice to MNEs. We believe the Discussion Draft includes many subjective terms that may be pejorative and, therefore, interpreted differently by rational decision makers.

- PwC further recommends that more time and consideration be devoted to the drafting and refinement of special measures. These proposals are at odds with the arm's length principle and could fundamentally change the existing transfer pricing rules as implemented by many countries. The proposals are very briefly described and we believe there is simply not enough time in the remaining few months of the BEPS project to give them serious consideration and to develop them in a reasonable manner.

These concerns related to the interlinking of this Discussion Draft and the overall complexity of the proposals are the key themes in our recommendations below. Overall, additional details are needed regarding the principles and suggestions presented in the Discussion Draft. Our detailed comments are presented below in a format that parallels the Discussion Draft’s structure.

**Part I – Guidance for Applying the Arm’s Length Principle**

Part I’s proposed revisions to Section D of Chapter I of the Transfer Pricing Guidelines emphasize the importance of accurately delineating the actual transactions in accordance with the substantive
commercial and financial relationships of the parties, in particular, adhering to a “commercial rationality test” one that requires “consideration of whether the actual arrangements differ from those which would have been adopted by independent parties behaving in a commercially rational manner.” (See para. 88).

The proposed revisions include guidance on the relevance and allocation of risk, determining the economically relevant characteristics or “fundamental economic attributes” of the controlled transactions, and recharacterisation or the non-recognition measures resulting as a consequence of the determination that the risk does not align with the contractual allocations in the transactions. Overall, we suggest to narrow the language in the Discussion Draft such that it only describes commercially rational solutions that would primarily rely on written contracts, only to be supplemented by the factual circumstances and course of dealings between the parties, and only subject to override if there is strong evidence of a lack of substance or other tax avoidance motives.

**Identifying the Commercial or Financial Relations**

Paragraph 1 of the Discussion Draft recognises that “a ‘comparability analysis’ is at the heart of the application of the arm’s length principle...” and that the “commercial or financial relations” between associated enterprises must be properly identified and delineated. The broad concept of commercial or financial relations could potentially encompass a wide range of relationships. Further clarification regarding what is considered a commercial or financial relationship (i.e., the scope of such relationships) in the context of the Transfer Pricing Guidelines would need to be established to prevent an analysis from potentially expanding beyond the tax and transfer pricing arena.

In the business environment common to many global MNEs, commercial contracts are often the cornerstone of the commercial and financial arm’s length relationship between independent enterprises. We are concerned, however, that the Discussion Draft treats contracts as a starting point subject to overriding perceptions of arm’s length behavior, instead of as the guiding factor in an arm’s length transfer pricing analysis. Paragraph 3 states that in situations where there is no written contract, or where the conduct of the parties demonstrates that the contractual terms are ambiguous, incorrect, or incomplete, the delineation of the transaction should be “deduced, clarified, or supplemented” with a review of the actual conduct of the relevant parties. The concept of deduction introduces a level of subjectivity into the analysis. Additional details on what level of deduction is permissible would be required, as many legal authorities rely on written contracts. We are concerned that the Discussion Draft allows tax authorities to more easily disregard transactions through the process of “accurately delineating” the transaction, rather than doing so only when a transaction lacks economic substance.

While we appreciate that recasting a transaction is intended as a last resort in the Discussion Draft, the language in Paragraph 3 raises the concern that such a consequence could occur by default. For example, under many domestic legal regimes, the contract itself is examined to make a determination of whether the terms are ambiguous or incomplete before any evidence of conduct is considered. Disregarding existing contracts is therefore extremely concerning and additional guidance on how to reconcile domestic law’s reliance on contracts with the Discussion Draft’s proposals to move away from this approach would be necessary to avoid uncertainty and confusion. For example, the relationship between the existing contractual terms and how they could potentially be overridden by a subjective concept of how independent parties should act or how the associated enterprises are actually dealing with each other would need to be considered further. We are concerned that the current wording in the Discussion Draft gives tax authorities wide latitude, on a subjective basis, to judge what is commercially reasonable and to second guess legitimate business transactions. This latitude may have serious implications for the certainty the arm’s length principle seeks to achieve and could make administration of transfer pricing issues chaotic.

Paragraph 7 introduces the concept of synergies that may have been created through “deliberate concerted action” or through other means such as know-how provided through seconded employees. The concept of synergies and their role in value creation is a complicated and highly debated subject in transfer pricing. Therefore, any conclusion that synergies exist based on a deduction derived from the
conduct of the parties should be guided by a specific framework. For example, the definition of “deliberate concerted action” should be clarified. Furthermore, an important point for clarification would be to understand how tax authorities should differentiate synergies that are created by deliberate concerted action versus common group synergies that naturally occur as a consequence of an associated enterprise’s status as a member of a controlled group. It would be useful if a methodology were provided to ensure that synergy recognition is consistent with the arm’s length principle and prevent drifting towards a formulaic apportionment approach. The concepts of “synergies”, “interdependencies”, “coordination”, and “integration” seem to be used inappropriately in the Discussion Draft to view an MNE as a “single firm”, justifying recharacterising transactions and disregarding contractual allocations of risk. In addition, guidance on how to apportion synergies within a group, if it has been determined that there is value from synergies that should be recognised, would be a useful clarification to include.

We agree with the Discussion Draft’s identification of functions performed, risks assumed, assets used, and other relevant economic characteristics identified in Paragraph 11 used to delineate a transaction for transfer pricing purposes. In addition to these factors, in Paragraph 12, the Discussion Draft identifies “options realistically available” to the parties as an economically relevant characteristic that should be utilized when examining how independent parties would evaluate potential transactions. While we agree with the Discussion Draft that in general, independent enterprises do compare the options realistically available, it would be useful to have some guidance as to the scope of realistically available options permissible for tax authorities to consider, as consideration of every possible alternative may obfuscate a focused analysis based on the contractually agreed transaction. It would also be useful to clarify whether the options realistically available are a comparability factor in the economic analysis or whether they are to be taken into account in another fashion.

The section on the functional analysis introduces the concept of “capability” as a factor in identifying the economic circumstances of the commercial and financial relations (Paragraphs 17-19). We are concerned that this introduces an unnecessary and inappropriate step into the functional analysis. First, in many cases, it would be challenging to assess and quantify the actual capabilities of different associated enterprises consistently. Additional guidelines on what factors would be considered when determining capability as well as measurement methods to be used would be needed. Second, the complex decision-making process of MNEs would need to be factored into any analysis related to capabilities. Parties can voluntarily allocate less than their actual capabilities to other associated enterprises for a wide range of business reasons, such as future perceived capabilities. Finally, we are concerned that this concept is incorrectly described and that it proposes that there be different pricing for the same transaction based upon the “capabilities” of the parties.

We agree with the Discussion Draft that business strategies are another factor that should be considered when delineating a controlled transaction and determining comparability for transfer pricing purposes (Paragraphs 10 and 31). However, business strategies can vary widely, and it is possible that even within a specific industry, a wide range of business strategies could be implemented by the various participants. Without further specific guidance and definition, an analysis of business strategy and its impact on a controlled transaction could lead to a subjective analysis of risk. More clarification on the structure and relative importance of such an analysis would be appreciated.

Identifying and Allocating Risks in Commercial or Financial Relations

We agree that the identification and allocation of risks is a crucial part of a comparability analysis. We observe that the framework provided for the analysis of risk in Paragraph 40 gives little importance to the role of financing the risk within the MNE group. In addition, Paragraph 66 indicates 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.” The role of financial risk is critical in transactions, and we believe it should not be disregarded as it is in the Discussion Draft. While we recognise that not every highly capitalised party carries risk, the Discussion Draft should acknowledge that the party assuming the financial risk contractually is usually in the best position to manage and control the risk, even if it does
not perform the day-to-day operational activities associated with the risk. For example, when a function is outsourced there are varying degrees of risk and control assumed by the contracting party. Therefore, a party could be performing risk management, but not necessarily managing or controlling the risk.

Page 14 of the Discussion Draft raises a question concerning the role that imputed “moral hazard” and contractual incentives should play with respect to determining the allocation of risk and other conditions between associated enterprises. The Discussion Draft asks how 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 should influence the allocation of risks between related parties. We believe that the issues of moral hazard and contractual incentives to guard against risk are already part of the functional analysis. By definition, a functional analysis under the arm's length principle determines how associated enterprises would function as if they had competing incentives regarding risk allocation; accordingly, such analysis would obviate the need to examine any incentives to insulate one party from the consequences of risk. It is not necessary for related parties to put in their contracts incentives or safeguards to align their interests, because their interests are already aligned. Consequently, it would not be appropriate to disregard transactions among related parties that do not include such incentives or safeguards, and the concept of imputed moral hazard is not helpful and could only confuse the analysis.

Under the risk management discussion, Paragraph 55 discusses outsourcing, which is a common business practice. The current discussion is too broad, and does not take into consideration the many unique factors that may ultimately lead a business to include outsourcing as part of its value chain. The Discussion Draft should recognise that outsourcing itself involves risk, and the fact that a company may decide to outsource does not result in that company losing control of the process or delegating all of the risk. Similarly, Paragraph 56 states that line management in business segments contributes to risk management, yet the Discussion Draft does not recognise that line management may not necessarily indicate that the top level reporting entity controls the risk, nor does it discuss how line management interplays with outsourcing risk.

Paragraph 61 states that a contractual allocation of risk may not be respected for arm's length purposes if a party does not have the ability to control the risk. This is supported by an example of a customer's contract with an unrelated insurance company. In addition to the fact that the example does not represent the circumstances faced by an MNE, the example fails to account for the risk that is taken by the customer (both transactional cost and the cost should the insurance not fully cover the damage cost). We believe that it would be useful to have an example that considers the issue of controlling risk versus contractual risk from the perspective of an MNE's allocation of risks.

In conclusion, with regard to allocating risk, it should be recognised that risk is contractually shared among associated enterprises, and even if there are reporting line structures, or competing capabilities that do not necessary align with the assumption of risk, such facts do not compel the conclusion that a transaction should be recharacterised because the associated enterprise possesses the top level reporting line or ability to control the risk. As a result, instead of disregarding written contracts, the Discussion Draft should prioritize written contracts as primary guides to the allocation of risk between associated enterprises and respect contractual allocations unless there is strong evidence of motives for organizing the form of a transaction contrary to substance.

**Part II – Potential Special Measures**

Part II of the Discussion Draft sets forth options for various special measures with regard to intangible assets, risk, and over-capitalization, as contemplated by the BEPS Action Plan released in July 2013. As indicated in the BEPS Action Plan, the main objective of the Transfer Pricing Guidelines is to align economic transfer pricing outcomes with value creation, in effect, to prevent “double non-taxation of income.” To achieve this alignment, the Action Plan suggests with regard to Actions 8, 9, and 10 that “special measures, either within or beyond the arm's length principle, may be required....” The Discussion
Draft contains a series of questions relating to the options with a view toward taking the responses to these questions into account when considering the appropriateness and design of each option.

First and foremost, any special measures need to be consistent with the arm's length principle. There are already many existing forms of guidance that provide direction on how transactions should be considered within the sanctity of the arm’s length principle. These include other Chapters of the Transfer Pricing Guidelines (such as Chapters I, III, V, VI, and IX), the other BEPS Action Plan items (such as the CFC action item), and domestic tax laws. For example, where a transaction may require the consideration of special measures, it is likely that the transaction would lack economic substance and would therefore be subject to existing doctrines or domestic tax regulations aimed at prohibiting tax avoidance. In addition the special measures, in their current state, are undeveloped as demonstrated by their short length and lack of substantial guidance. Taking into consideration the BEPS initiative’s timeline of finalizing its proposals by the end of 2015, we would recommend that a more reasonable, lengthened timeline be adopted for the special measures section. Doing so would also ensure that any such special measures would not be implemented until the other BEPS Action Plan items, including revisions to other sections of the Transfer Pricing Guidelines, are finalized. At this time, it would then be possible to determine what, if any, additional measures would be required and how they should be implemented.

Additionally, we note that if special measures are recommended which are outside of the arm’s length principle, Article 9 of most income tax treaties would need to be renegotiated in order for countries to implement them. Instances of double taxation which arise from use of special measures inconsistent with the arm’s length principle would not be eligible for resolution under the Mutual Agreement Procedure. We consider that to be another important reason for the Discussion Draft to be consistent with the arm’s length principle, otherwise the unfortunate result will be an increase in intractable cross-border tax controversies, negatively impacting world trade and economic development.

Furthermore, generally governments have indicated a reluctance to recast or recharacterise transactions unless strict and defined rules are developed and implemented. We appreciate the sentiment that recharacterisation or non-recognition is exceptional; however, the current guidance is ambiguous as to what circumstances are exceptional, and when special measures should be utilized by tax authorities in such exceptional circumstances. Overall, additional elaboration is required on how these special measures would function in practice. There needs to be clear standards for such measures. Failure to clearly define and delineate such special measures could potentially add another layer of complexity to the existing treaty and mutual agreement process. In addition, failure to clarify the application of special measures could also cause discord between the interpretation of longstanding domestic country tax statutes and the arm’s length standard, such as the “commensurate with income” statute in the United States Internal Revenue Code. While tax authorities and judicial bodies generally try to interpret statutes in a manner that ensures consistency with treaty principles such as the arm’s length standard, adding this additional layer of ambiguity will only cause more uncertainty for taxpayers when it comes to reliance on their own domestic legal tax regimes.

Summary of key points

Our key areas of concern with respect to the Discussion Draft are summarised as follows:

- Other aspects of the existing Transfer Pricing Guidelines already provide a reliable framework to ensure the sanctity of the arm’s length principle in the context of risk characterization and allocation. We are concerned that the Discussion Draft prescribes potentially inconsistent guidance with rules already enacted or promulgated under domestic tax regimes that rely on the existing Transfer Pricing Guidelines.

- With respect to applying the arm’s length principle, we are concerned that the current wording in the Discussion Draft gives tax authorities wide latitude, on a potentially subjective and arbitrary
basis, to judge what is commercially reasonable and to disregard the terms of legal agreements between parties that are part of legitimate business transactions.

- The Discussion Draft introduces the concept of synergies that may have been created through “deliberate concerted action” but does not provide a specific framework on how such synergies would be identified. The concept of synergies and their role in value creation is a complicated and highly debated subject in transfer pricing. We are concerned that the concepts of “synergies”, “interdependencies”, “coordination”, and “integration” seem to be used inappropriately in the Discussion Draft to view an MNE as a “single firm”, justifying recharacterising transactions and disregarding contractual allocations of risk.

- Finally, governments have generally indicated a reluctance to recast or recharacterise transactions unless strict and defined rules are developed and implemented. We appreciate the sentiment that recharacterisation or non-recognition is exceptional; however, we are concerned that the current guidance is ambiguous as to what circumstances are exceptional, and when special measures should be utilized by tax authorities in such exceptional circumstances.

* * *

On behalf of the international network of PwC Member Firms, we respectfully submit our response to the OECD BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures). For any clarification of this response, please contact the undersigned or any of the contacts below.

Yours faithfully,

Isabel Verlinden
Partner
PricewaterhouseCoopers, Brussels

Adam M. Katz
Partner
PricewaterhouseCoopers LLP, New York

cc Stef van Weeghel, Global Tax Policy Leader

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To Mr. Andrew Hickman - Head of Transfer Pricing Unit, Centre for Tax Policy and Administration.

Email: TransferPricing@oecd.org

Dear Mr. Hickman, dear Andrew

Please find attached the comments of Quantera Global in respect of the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures).

Kind regards,

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Comments on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures)

By

Quantera Global
Quantera Global welcomes the opportunity to provide its comments to BEPS Actions 8, 9 and 10: Proposed Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures) ("Discussion Draft").

We highly appreciate the work that the OECD has done so far and appreciate the difficulty of the matter. We have opted to provide more general comments on the Discussion Draft.

We look forward to discussing these matters in more detail during the public consultation in March 2015.

General observations

Actual conduct versus contractual terms.

The BEPS actions provide a wide range of measures to battle tax avoidance. Although we appreciate this focus it should be clear that the main goal of the Transfer pricing guidelines is to provide general guidance on the application of the arm’s length principle. We believe it to be essential to maintain the basis assumption that transfer pricing and the application of the arm’s length principle is business driven and not a mere instrument to avoid taxes. The anti avoidance measures and clarifications on potential abusive behaviour should remain exemptions and not become the new standard.

The detailed focus on abusive behaviour should avoid any suggestion of some standard assumption that taxpayers in general are expected to behave in an abusive manner. We would welcome a firm confirmation of the basis assumption that taxpayers are expected to make appropriate efforts to be compliant with the arm’s length principle.

Starting from this basis assumption we believe that any assumption of abusive behaviour should require special scrutiny. Taxpayers usually make quite an effort to be compliant with the arm’s length principle. Due to the complex nature of business and the practical difficulties in application of the arm’s length principle there will always be room for different interpretations. Therefore we would welcome if taxpayers would be given some comfort that any ‘substance over form’ discussion would require the party claiming the deviation from the ‘form’ to provide sufficient proof that would substantiate such position.

Throughout the Discussion Draft many instances are addressed where contractual terms might be set aside based on actual conduct of the parties involved in the transactions. The multiple examples of potential discrepancies between contractual terms and actual behaviour might suggest that this would be a default assumption. Although we fully support the reasoning to do so and agree with the conceptual approach to take the actual behaviour of taxpayers as decisive facts to determine the true transactions, we do belief additional guidance is required on the burden of proof. We would welcome a firm statement that written contractual terms are assumed to represent the correct intentions and agreements between taxpayers unless proven otherwise. Only in case it is clear that actual conduct deviates from the contractual terms tax authorities should have the opportunity to overrule the contractual agreements. The current wording that refers to “.. written contractual agreements ... provide the starting point...” does not provide clear guidance in respect of the allocation of the burden of proof. Taxpayers need to be
protected from arbitrary positions by tax authorities already in the Guidelines as it is to be expected that dispute resolution may become quite a challenge as a result of all BEPS actions and the non existence of a consensus on the application of mandatory arbitration in MAP.

**Separate entity approach**

We believe the separate entity approach to be at the heart of the arm’s length principle. The Discussion Draft however seems to move away from this basis assumption without proper justification. An example may be Paragraphs 18-19 where arguments are raised that address a group of entities as a whole rather than as separate entities. The reasoning is not convincing. The example addresses a group insurance company and suggests that such a group insurance company would not provide for any risk diversification as this would already be provided by the group as a whole. We do appreciate the diversification argument but we belief there would be no need to step away from a separate entity approach to properly apply the arm’s length principle. If multiple entities within a group would combine their insurances in one group captive insurance company there might actually be true diversification of risks from the perspective of the group companies. Therefore a realistic comparison with third party insurance companies could be made.

**Risk allocation**

**Moral hazard**

We believe the issue of moral hazard might already be dealt with as part of the arm’s length principle. The concept of allocation of risk to a party in a transaction that has relatively more control over that risk seems to make sense. However we feel it might be made more clear that some form of moral hazard may also occur between third parties and therefore the mere existence of some moral hazard should not justify any adjustment by tax authorities. Reducing moral hazard may be a goal but achieving it should not be taken for granted.

We feel too much focus might be put on risks that can be managed and controlled in some way by taxpayers. To the extent control would be feasible the general approach could provide for a practical guidance on the allocation of such risks. However in practice there are also risks that may not easily controlled by taxpayers although the risks are real and may have substantial impact on the business when they materialise (e.g. earthquake, flood, etc). If no realistic control is possible by individual taxpayers some additional guidance would be welcome on the allocation of risks. In that respect it could be appropriate to refer to the capacity to bear such risks. A statement as provided for in paragraph 78 seems too absolute and should be adjusted to take into account risks that cannot be controlled.

**Non-recognition**

Non-recognition should be an action of last resort. We therefore welcome the clear language as included in the Discussion Draft to clarify this. We do fear however that the reference to “same transaction” in paragraph 84 might be interpreted too strict and would suggest to amend the wording to “similar transaction”.

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We believe there is a difference between non-recognition of a transaction and recharacterisation. The Discussion Draft however stipulates in paragraph 83 that both terms should be understood to have the ‘same meaning’. This may be confusing. Non-recognition might result in assuming that no transaction has taken place as is illustrated by the example in paragraph 92 where it is stated that the trademark is considered to be not transferred. The term recharacterisation seems to imply that there is a transaction identified but it is different from the one presented. Also paragraph 93 seems to assume that an alternative transaction would be identified. Recharacterisation of transactions could be seen as just another way to come to a true identification of the actual transactions undertaken. We suggest to clarify the wording to avoid misunderstanding. In case of non-recognition it might be preferable to just ignore the purported transaction and act as if it had not occurred. This could potentially result in much cleaner discussions that would only need to consider whether the transaction would be recognised or not.

**Special Measures**

Special measures should be limited to abusive behaviour that could be linked to tax avoidance. We therefore would like to suggest to include such limitation to the application of special measures.

**Option 1: Hard-to-value intangibles**

The Discussion Draft links the measure to fixed prices or royalty rates. One could expect discussions about when prices should be considered ‘fixed’. The guidance might elaborate on this to provide better guidance to taxpayers when to expect application of the special measure.

The wording refers to not having ‘any’ contingent payment mechanism. This would allow fixed payments with only minor contingent payments to avoid application of the special measure. If this is not intended we suggest to elaborate further on when contingent payments would be considered substantial enough to avoid application of the special measure.

The guidance does not provide any clarity about how an adjustment mechanism should look like. We suggest to provide for a simple and clear mechanism in the guidance that should be applied in case of adjustments by tax authorities. This to avoid arbitrary and opportunistic mechanisms imposed upon taxpayers.

We support the option of a rebuttable presumption. However we would like to suggest to reverse the process. We feel it would be reasonable to apply a basic assumption that the transaction is based on proper projections by the taxpayer. If a party would like to claim application of a presumed adjustment clause it should be able to demonstrate that no proper projections were established by the taxpayer.

**Option 2: Independent investor**

If there is someone with no functionality and no knowledge to judge an investment this would be comparable to providing a risky loan and could therefore be remunerated with an interest percentage. If an investor can however judge the risk he is taking and provide some guidance it would be dependent on the specific case what the remunerations will be of the parties involved. We feel the deviation in functionality between the parties is set somewhat extreme while in practice it would generally be less ‘black and white’.
Option 3: Thick capitalisation

We do not consider Thick capitalisation to provide for a solution that would be aligned with basis transfer pricing principles. The mere reference to financial ratios would ignore specific analysis in respect of functions and risks according to the general guidance. Applying such limitations might result in structures reorganised to avoid application. The reference to certain ratios within the financial services industry might not be a reasonable approach as it would seem to provide for measures that might erode the very goal of those regulations, being to make sure that sufficient capital is at hand to cover the risk exposure. It might be considered to exclude certain business that already has to comply with other regulations such as insurance and banking.

Option 4: Minimal functional entity

We feel this option is not required as this should be covered by a proper functional analysis and a related appropriate arm’s length return. The reference to outsourcing of functions as a trigger for special measure would not be aligned with earlier statements that such outsourcing would be acceptable. The reallocation of profits seems to have no link at all with the arm’s length principle. Using a predetermined profit split would not make sense as companies may differ substantially and it would be expected that using a pre-determined factor will result in arbitrary allocations.

Option 5: Ensuring appropriate taxation of excess returns

We feel implementing CFC rules should not be part of the transfer pricing guidelines.
2 February 2015

Dear Sir/Madam

BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures).

We are writing in response to the OECD’s request for comments in relation to the Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines released on 16 December 2014.

Reed Elsevier is a world leading provider of professional information solutions. We operate across several professional market segments through five business divisions comprising of Elsevier, LexisNexis Legal and Professional, LexisNexis Risk Solutions, Reed Exhibitions and Reed Business Information. Reed Elsevier operates in more than 30 countries and employs approximately 28,500 people worldwide.

We set out below our representations on the discussion draft. Our representations are focussed on the key issues for our business and are organised by what we consider the main themes brought out by the new and updated sections included in the discussion draft as follows:

- Identification of the commercial or financial relations between the associated enterprises
- Identifying risks in commercial or financial relations
- Recharacterisation and non-recognition
- Special Measures

**Identifying the commercial or financial relations**

1. Paragraph 3 of Section D1 indicates that the contractual agreements between the related parties should be the starting point for the analysis. Reed Elsevier welcomes this approach as we invest a significant amount of time in preparing agreements which accurately reflect our related party transactions. We also support the position that the actual conduct of the parties should overrule the contractual arrangements where the two are inconsistent but would suggest that the wording of this section be revised to expressly state that the terms of the contractual arrangements can only be disregarded where there is clear evidence to show that the conduct of the parties differs materially from the terms of those contractual arrangements.
2. In our opinion, the most appropriate method for determining the actual conduct of the parties would be through a functional analysis which, in accordance with the OECD Guidelines on transfer pricing documentation, would be included as standard in an multinational enterprise’s (MNE) transfer pricing documentation as part of the master file or local file for all significant transactions.

3. The level of analysis required in order to ‘test’ the actual conduct of the parties to determine if there are any inconsistencies with the terms of the agreement may be quite detailed, involving functional analysis interviews with key members of the business. For a tax administration to carry out this type of analysis for all related party transactions within an MNE would create a significant burden on resources, both within an MNE and within the tax administrations themselves. It is therefore our view that this type of analysis should only be conducted on a risk based approach, once the tax administration has conducted an initial review of the MNEs transfer pricing documentation.

**Identifying risk in commercial or financial relations**

4. In general, we do not consider that the identification and treatment of risks under the arm’s length principle should be any different to the process for functions and assets. We consider that the starting point for this should be the contractual arrangements between the related parties together with transfer pricing documentation prepared by the MNE. As with functions (see point 1 above), we consider that the terms of the contractual arrangements should only be disregarded where there is clear evidence to demonstrate that the actual risk borne or managed by the parties to the agreement is not consistent with the contractual arrangements.

5. Paragraph 38 of Section D2 introduces the concept of “moral hazard.” The additional points on page 14 explain this term as referring to “the lack of incentive to guard against risk where one is protected from the consequences” and additionally states “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”. It is our view that enterprises within an MNE are not always protected against risk through the existence of common control and can often be subject to the same risks as unrelated parties. Additionally we do not agree that associated enterprises will always operate collaboratively to maximise the group profits. Entities within an MNE may be set individual targets in relation to their own performance and may therefore operate to achieve their own targets, rather than operate in a way which would maximise overall group profits. The terms of contractual arrangements are often strongly negotiated between associated enterprises and therefore the risks identified under the terms of related party contracts cannot be simply disregarded.

6. The transfer of risks is discussed in various paragraphs of Section D2 of the discussion draft. In line with our comments at point 4, we do not consider that the treatment of risks should be any different than the treatment of functions or assets in this respect. As long as the functional analysis demonstrates that the actual risks borne by the associated enterprises are consistent with the transfer that has taken place and the transaction is priced accordingly, then the transfer of the risks should be recognised.
Recharacterisation and non-recognition

7. We do not consider that recharacterisation of a transaction should be required unless the actual conduct of the parties is materially different from that which the pricing of the transaction is based upon. We are therefore in agreement with the comment at Paragraph 81 of section D3 which states that “every effort should be made to determine pricing for the actual transaction as accurately delineated under the arm’s length principle”. The use of recharacterisation should therefore be exceptional rather than a standard approach.

8. Section D4 discusses the concept of non-recognition of transactions where the transaction “does not have the fundamental economic attributes of arrangements between unrelated parties”. It is our view that most MNEs would only enter into arrangements with associated enterprises for genuine commercial reasons to the benefit of all parties to the arrangements. We would therefore always consider such arrangements to have the fundamental economic attributes of arrangements between unrelated parties and would therefore only expect non recognition to apply in extremely rare cases. It is our view that it would helpful to include some additional detail around this in the guidance, specifically a list of indicators that would demonstrate a transaction had the fundamental economic attributes of arrangements between unrelated parties, or additional examples.

9. Paragraphs 90, 91 and 92 of Section D4.2. provide an example of a transaction which is considered to lack the fundamental economic attributes of arrangements between unrelated parties. While we consider that the transaction would be more likely to have the fundamental economic attributes of arrangements between unrelated parties if Company S2 carried out the marketing functions in relation to maintenance and enhancement of the trademarks, we do not agree that there is sufficient information presented in the example to conclude that the arrangement does not enhance or protect the commercial or financial position of either company. There is insufficient information regarding the activities undertaken by company S2 in relation to the assessment, monitoring and direction of the use of the trademark to assess whether these activities provide a valuable commercial benefit to the parties to the transaction.

Special measures

10. Point 6 of the introduction to Part II of the discussion draft considers whether there should be special measures that are within or beyond the arm’s length principle. It is our view that any special measures should not go beyond the arm’s length principle. The arm’s length principle is the globally recognised approach for transfer pricing and MNEs spend a substantial amount of time and incur significant expense to ensure that arrangements between associated enterprises are consistent with the arm’s length principle. The introduction of special measures that go beyond this principle is unnecessary and creates further uncertainty regarding the transactions that take place between associated enterprises within an MNE.

11. It is our view that the pricing of transactions based on a thorough functional analysis under the arm’s length principle is sufficient to achieve the intention of ensuring that each party to a transaction is adequately rewarded for the value it creates in relation to the transaction. We therefore consider that the special measures should not be used by tax administrations as a starting point instead of a detailed analysis under the arm’s length principle. If the special measures are needed at all they should be reserved for exceptional circumstances and clear criteria should be included in the guidance to indicate when the special measures apply.
12. The guidance on the individual special measures is not sufficiently detailed to provide detailed comment on these measures as, without knowing the specific criteria that would apply to each measure, it is difficult to assess the potential impact that each measure would have on Reed Elsevier.

We would like to thank you for providing us with the opportunity to comment on the discussion draft and look forward to being included in the discussion process.

Yours faithfully

Paul Morton
Catherine Harlow
Paul Hewitt
February 4, 2015

OECD BY EMAIL: TransferPricing@oecd.org

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

Dear Sir:

Re: Public Discussion Draft, BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization and Special Measures) released December 19th, 2014 (the “Draft”)

Executive Summary

1. The Draft represents a major shift away from the arm’s length principle to a system based on the Authorized OECD approach underlying Article 7 of the OECD Model Tax Convention. The latter produces results which are not at all congruent with those produced by the arm’s length principle.

2. The Draft changes the focus of the Transfer Pricing Guidelines from finding the right price or at least a reasonable one to recharacterizing transactions to resemble more closely what are deemed to be transactions found between arm’s length parties and then determining prices. If the Draft is adopted, a transaction may be recharacterized even if it can be reliably priced. Recharacterization of transactions that can be reliably priced serves no purpose and is not in the best interests of taxpayers or governments.

3. Entirely new tests are proposed that have little or no commonly understood or objectively verifiable meanings. They will afford a large measure of discretion to revenue authorities in their application of the transfer pricing rules.
4. The OECD must ensure that Binding Arbitration is accepted by all OECD countries before any proposed changes are adopted to ensure that the discretion exercised by the revenue authorities is controlled and does not result in inconsistent treatment of a taxpayer by different countries.

**Detailed submission**

The observations herein regarding the Draft should not be viewed as exhaustive and represent the personal views of the authors and not necessarily the firm, Osler, Hoskin and Harcourt LLP.

**A. A shift away from the arm’s length principle to allocation of profits based on Article 7 and the AOA**

The Draft advocates a dramatic shift away from the arm’s length principle (the “ALP”) as outlined in the OECD Transfer Pricing Guidelines (the “TPGs”) towards a regime based on the Authorized OECD Approach (“AOA”) now prescribed for OECD Model Article 7 attribution of income to a permanent establishment.

Under the previous TPGs, the legal form and substance of transactions entered into between non-arm’s length (“NAL”) participants were respected, except in rare and exceptional circumstances. The Draft proposals abandon this presumption. The Draft fundamentally shifts gears to propose that the legal form and substance of transactions carried out by NAL parties routinely be ignored based on an examination of the “fundamental economic attributes” (“FEA”) of a transaction – a new test that appears to be somewhat akin to an economic substance determination – and the tax consequences be determined based on another new test based on “value creation” (“VC”), but only for transfer pricing (“TP”) purposes.

This new VC criterion: is not well-defined; does not have a well-understood meaning; is based on subjective criteria; and is to be applied without any thought given to collateral consequences arising from its application.
As indicated in paragraph 1, page 38:

“As the BEPS Action Plan indicates, the main aim of the Transfer Pricing Actions (8-10) is to assure that transfer pricing outcomes are in line with value creation. The BEPS Action Plan also indicates that in order to achieve this aim “special measures, either within or beyond the arm’s length principle, may be required with regard to intangible assets, risk and over-capitalisation.”

In other words, revenue authorities can ignore legal form and substance for TP purposes and re-determine the terms and conditions of a NAL transaction based on perceived VC criteria which may but will not necessarily yield terms and conditions that are in accordance with the ALP.

There are numerous questions regarding the basis of this new VC test. What is the legal or other basis for the proposition that determinations based on VC will meet the requirements of arm’s length (“AL”) terms and conditions as mandated to be determined by Article 9 of the OECD Model Tax Convention (and by actual treaties based thereon)? Will the multilateral instrument provide for amendments of affected treaties to so provide?

The Draft replaces references to AL terms and conditions with a new VC benchmark which if adopted will make key elements of the AOA applicable for Article 9 TP purposes – which benchmark was specifically rejected at the time the AOA was introduced. Has the OECD considered all the reasons why it was not so applied at that time?

What does VC mean in this Article 9 context? Can it be applied easily in practice – for example by reference to comparable uncontrolled prices (“CUPs”) – or does it require a complicated analysis in respect of formerly routine determinations of the transfer price of ordinary goods and services?

Is there a generally accepted legal meaning of VC available to courts and revenue authorities?
There is no reference to VC at all in the 1995 or 2010 TPGs. If VC was synonymous with AL results (or even nearly so), it surely would have been mentioned before now in the TPGs. The VC test is simply not congruent with the ALP. It is a new test that gives overriding weight to the location of “significant people functions” ("SPF") in accordance with the AOA methodology. While the G20 has mandated this result, pretending it accords with the ALP will just make matters much worse for all concerned; the OECD should just admit that the new VC test is a replacement of the ALP.

If VC is to be the new test, then domestic laws that are based on the ALP will have to be amended. Canadian TP tax law at least is expressed in ALP terms and does not give legislative status to the TPGs. Reliance on VC will require legislative amendments. Will the OECD require countries to amend their legislation by a certain date in order to apply this new VC test?

Introducing new tests or principles is always troublesome. VC is a new test without a track record. Is there broad international consensus on the meaning of VC and what it means from a TP perspective in the context of the myriad of cross border transactions that occur today? Once one abandons reliance on legal substance and the ALP – which has some history and an intuitive meaning – as guiding principles in favour of another test without a well-defined commonly understood meaning in this context, the risks are: a lack of consistency; a lack of predictability; and higher costs of compliance with an unestablished standard. At best, it will take decades to reach a steady state where a reasonably well-accepted meaning prevails in most jurisdictions. Very basic questions regarding the application of the ALP (e.g. implicit support, whether related license agreements are to be considered in relation to sales of goods, etc.) are still being litigated and the ALP has been in use for several decades. There is no doubt that the number of TP disputes will increase, which is detrimental to both businesses and governments who will require significant more resources to expend for TP.
Everyone believes or at least maintains that they add value – even lawyers and accountants. How will taxpayers and revenue authorities decide which service providers really do add value and how much in relation to particular transactions? As outlined below, it appears that it will no longer be possible to simply value any service provided based on market terms. If value created is to be determined without objective criteria – i.e. largely in the eye of the beholder – how are competent authorities going to deal with mutual agreement procedure cases?

Have governments have really thought through the practical implications of this change insofar as the effects it will have in the amount of tax revenue they will collect in the long run? Will businesses adjust by moving SPFs? Will businesses outsource more functions to AL service providers so as to achieve results formerly achieved using the ALP?

B. Multinational Enterprises (“MNEs”) are not to be trusted

Another significant shift in the Draft is the negative characterization of MNEs. Previously, in the 1995 and 2010 TPGs, the transactions undertaken by MNEs were respected based on their legal form and substance – except in rare and exceptional circumstances. The Draft assumes MNEs routinely misrepresent the actual facts. It is always necessary for revenue authorities to verify that actual MNE conduct is consistent with contractual terms as “it should not be automatically assumed that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties”. The suggested audit starting point has changed. MNEs are presumed to enter into agreements that do not “reflect a complete picture of the transactions” or are “incorrectly characterised or labelled” or are “a sham”.

While revenue authorities may already have had this mindset in respect of MNEs, by stating it explicitly, the OECD will embolden them and make audits even more difficult for taxpayers. In the TP world, there seems to be a reverse onus for taxpayers – they are guilty of tax avoidance unless proven innocent – and the Draft seems to endorse this view. This may well cause senior executives who do not view themselves or their organizations
through this prism to be much less amenable to adopt a cooperative position with the revenue authorities.

C.  **Labour vs Capitalists**

The Draft suggests that the *mere* provision of capital should entitle the provider to little or no return where the provider does not have the wherewithal to manage or exploit the capital on its own. The presumption is that capital providers should receive at most a financing return, while residual returns should be ascribed to the contributions of labour.

The formerly basic TP rule is that one usually starts by testing the simplest party – or at least the one for whom remuneration can most reliably be determined. That methodology has been replaced. The prevailing rule is now that residual returns are ascribed to the workers – even if the value of their labour is easily determinable.

If the service provider functions can be reliably priced, why doesn’t the residual go to the capital provider who takes the financial risk and whose appropriate return will likely be much harder to reliably determine? The OECD’s answer appears to be because it is now considered too easy to shift capital to a low tax jurisdiction and earn returns there without being subject to “proper” tax levels. But does it really make sense to subvert the determination of AL terms and conditions in order to overcome defects in country tax laws? Of course not. This is a slippery slope that will likely lead to unforeseen unwelcome consequences. For example, what will happen if taxpayers do shift the SPFs to low tax jurisdictions and capital is provided by the high tax ones? Will the system have to be rejigged yet again – back to the ALP?

In real life, fund managers for example, routinely manage other people’s property for a set fee or percentage of the amount invested. In more actively managed venture capital funds, they may even be entitled to a percentage of gains – e.g., maximum 20-25%. But the Draft provides that service providers should be entitled to 100% of the residual profits despite having zero risk of loss and without regard to their lack of capacity to bear losses. The
latter inconvenient truth is overcome by imputing capital contributions to service providers – see Option 2 below. This approach – it is claimed – is in line with how AL parties would behave. Of course, no empirical evidence is offered in support of this premise and it flies in the face of obvious situations such as that of the fund managers noted above.

AL service providers do not typically bear losses – e.g., an investment manager gets a minimum fee no matter what happens and investors alone bear losses. Similarly, in the context of research and development (“R&D”), although it is obviously not possible to say that it never happens, personal experience supports the view that in AL contract R&D arrangements, the service provider does not typically bear the risk of loss if the R&D efforts prove fruitless.

The Draft states that the service provider will bear all losses for TP purposes in conformity with the gain assumption situation. It is not entirely clear how this will work in practice. Will the entity providing services to the capital providing entity actually be deemed to compensate the capital provider for losses incurred – when it has no legal obligation or capacity to do so – so as to eliminate a deduction for tax purposes of a real economic loss suffered by the capital provider? If the service provider is not able to make such a payment because it is very thinly capitalized (since it does not legally assume any risk of loss) it appears the TPGs will create a fictional capital contribution by someone in control. What if the capital provider has minority third party shareholders?

Option 2: Independent investor on page 42 of the Draft states:

“Transfer pricing rules, including the guidance in Part I of this discussion draft, focus on the functions actually performed in relation to those assets, including the management of risks, and may determine that little or no return is due to the capital-rich, asset-owning company, and in some circumstances may determine that the resulting intra-group transactions relating to that company’s assets should not be recognised.”

“The target for this option is circumstances where the capital-rich, asset-owning company depends on another group company to generate a return from the asset. The option supposes that an independent investor having the option of investing in either of the two companies (i.e. the capital-rich, asset-owning company or the company that the former relies
on to generate a return from the asset) would consider which company offered the better investment opportunity, taking into account expertise in conducting risk-managed activities to generate a return on the investments and the level of risk and potential return. 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."

“In such circumstances the capital would be deemed to have been contributed to the company providing the more rational investment opportunity to an independent investor, and that the company would be deemed to have used the capital to acquire the asset, with the result that no return would be attributed to the capital-rich, asset-owning company.”

It is difficult to imagine any logical AL basis for providing no return to the capital-rich asset-owning company, despite the capital-rich company legally bearing the risk and providing funding. The OECD theory that a rational investor would always invest in the service provider rather than the capital provider is clearly not supported by AL facts such as the case of the investor / fund manager. AL third parties routinely invest in funds or projects managed by independent service providers.

The obvious question as to whether the services provided can be reliably priced is not even raised under the new OECD theory because residual profits simply must not be ascribed to the capital provider for TP purposes even if they would be in third party situations – as per the G20 mandate. The OECD TPG focus will thus shift from proper AL pricing to recharacterizing transactions to produce what are deemed by the OECD (but not AL parties) to be more politically acceptable TP results and thus to preclude Base Erosion and Profit Shifting that can otherwise be achieved under the ALP. The ALP is obviously capable of dealing with these situations and produces the more appropriate TP results – just not the more politically acceptable ones.

Consider the following example in assessing whether this new VC regime will always achieve desirable results – from a TP or politically acceptable perspective.

Assume that PCO, a non-Canadian family-owned company, develops and operates (via its 100% owned service subsidiary SCO) individual resort properties in various jurisdictions.
PCO establishes separate companies (“CCO”s) to own individual projects around the world. PCO always takes a majority (51%) voting equity stake in each CCO company. Minority AL equity investors are invited to invest in the CCOs. The legal agreements stipulate that each CCO will pay SCO a menu of fees for developing and running the property the CCO acquires and operates. For example, the operating fee would be cost plus 10% of salaries and other expenses allocable to the property. SCO provides high level management from abroad and seconds low level managers to the CCOs as required.

CCO Canada (“Canco”) is a Canadian company formed and controlled by PCO that owns a resort property in Canada. It has only very junior level non-SPF type permanent employees. Canco and SCO are deemed not to deal at arm’s length under Canadian tax rules (since they are both controlled by PCO) and thus the Canadian transfer pricing rules apply to the SCO-Canco contract. Based on the Draft, the legal agreements between SCO and Canco would seemingly be disregarded. SCO will not be limited to a cost plus 10% fee for TP purposes. SCO will instead be deemed to earn virtually all the income and ultimate gain actually realized by Canco in respect of its Canadian resort property. Canco would under the Draft be considered to earn no return – or at most a routine return on its capital – for TP purposes.

The proposed recharacterization under Option 2 purports to emulate an AL result but in fact completely fails to achieve a real AL world economic result. Even without Option 2, for TP purposes, the terms of the SCO-Canco services agreement would be disregarded – so that much larger fees will be considered paid to SCO as it better accords with the VC rule than the actual agreements (and the AL result).

The treatment of potential AL minority shareholders and lenders who provided funding to Canco is not considered in the Draft. If Canco does not actually pay the amount it actually earned over the VC determined amount to SCO, as it is not legally required to do so, it may trigger a deemed dividend or other payment from SCO to Canco or PCO resulting in
additional tax being levied on Canco thus impacting the return to the AL shareholders of Canco.

What happens if Canco’s resort operation incurs losses instead of the expected profits? Under the Draft rules, SCO will presumably be deemed to make full restitution to Canco in order for Canco to avoid loss realization (per Option 2) or to obtain a limited return under the VC test. But of course PCO has no legal obligation to fund SCO so as to permit it to make Canco whole. Will it be deemed to have done so? Will the AL shareholders of Canco also be denied loss recognition for their local tax purposes?

What if high level decisions as to which jurisdictions to invest in and which properties to acquire are made by PCO personnel – the family members? Does that mean the above analysis is all wrong and that all returns now are ascribed to PCO based on a FEA analysis? See the example in Item 4 below for a discussion of this question.

The application of Option 2 or the VC test to the situation described above obviously makes no sense. Common sense would of course dictate that the terms and conditions of the service contract between SCO and Canco must be AL otherwise the minority investors would not have invested. But it serves to illustrate that some of the basic premises of the new regime can produce results that are clearly not in accordance with those produced by the ALP.

The increased incidence of recharacterization arising under the VC and FEA tests creates many more opportunities for a fictional TP regime to conflict with the “legal substance” world that applies for general commercial purposes. This will at a minimum lead to increased incidents of double taxation which will not help promote international trade. There will inevitably be significant differences in the perception of how much “value creation” is attributable to each party by different revenue authorities and given that there is little or no hope that binding arbitration will be available per the recent OECD report on
Action Item 14, these differences will manifest themselves in even more TP disputes and resulting litigation.

D. “Value creation” – the right paradigm?

It might seem at first blush that value creation is a much fairer more equitable method to use as a basis for the allocation of income than market prices. Perhaps it would be – in an ideal world – but we live in a largely market based world. Further, when one layers on the artificial attribution of excess returns to service providers, as prescribed in the Draft, the results can be absurd.

Consider a public automobile company, Carco, whose shareholders provide capital to it. Carco hires employees, who “create value” for the company (the “value creators”) by designing, manufacturing and testing cars that are then sold to independent dealers. The shareholders do not run the company, and would have no idea whatsoever how to do so – as is the case with most shareholders of public companies. But despite the existence of value creators, residual profits generally arise and accrue to the shareholders. The value creators are paid salaries determined by market forces.

If one were to apply the VC test to this case, the value creators should be allocated all of the residual profits derived by Carco, while shareholders should earn at most a small return on their capital for transfer pricing purposes, since Carco has no way of exploiting its capital without its human value creators.

Using the logic outlined in the Draft, who would invest in a company that only has cash and no humans to put the capital to productive use. It might be argued that the Draft would not apply since Carco has employees. But does it really matter whether the human value creators are dependent or independent agents if the issue to be determined is simply the AL amount that should be attributed to the human functions performed by the value creators for Carco.
It can of course be argued that Carco must have some high level management to direct independent contractors, but as the real world demonstrates, they can be hired at determinable market prices that still leave residual profits with the shareholders.

E. **Even if it can be reliably priced, let there now be recharacterization!**

The current TP regime in the TPGs has a very practical and sensible rule: transactions as structured by the parties are almost always to be respected (assuming they have legal substance), and in any event if a transaction can be reliably priced, there is to be no recharacterization. The Draft abandons this rule.

Even if a legally binding transaction can be reliably priced, if the FEA of the transaction do not align with (a tax auditor’s view) of what they should be, the transaction would not be recognized for transfer pricing purposes.1

This new standard is explained as follows in paragraph 89:

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.

This presumption introduces a whole new dimension of complexity and introduces yet another new principle to be interpreted – presumably in furtherance of obtaining results in accordance with the ALP.

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1 It can of course be argued that taxpayers can have resort to the Courts if they do not agree with the auditor. But of course, litigation is a very expensive exercise and this new condition has no jurisprudential history upon which to make an intelligent prediction as to outcome. That is not a preferred result.
What degree of conformity is required between the FEA of a transaction and the hypothetical AL ones to escape recharacterization? As worded, it would appear that even if 99% congruency of the FEA of a NAL transaction with the FEA of the notional AL one is achieved, the transaction fails to pass the new test and is to be recharacterized.

Let us consider a very simple common situation. A Canadian company (“Canco”) has run out of markets in Canada and is considering expanding into the US by establishing a separate US subsidiary (“USco”). How is the FEA analysis to be conducted? Can the creation of a US subsidiary to exploit that market pass this FEA test?

Assume Canco will need to second some key employees to the USco and that it will appropriately fund it with capital. Canco will also license any needed intellectual property to USco to permit it to initiate and carry on its US business. Any property (including, any capital, license, or goods) or services provided by Canco to USco will be provided at an AL price.

By forming USco, Canco will forego earning significant profits that it firmly believes it would otherwise have earned had it carried on the US business as a branch – for no consideration. When we test this arrangement under the FEA guidelines quoted above, we presumably cannot consider Canco’s expected return as a 100% shareholder – since that would result in the sale of anything to such a subsidiary at a nominal (or indeed at any price) as meeting the requirements of the FEA and ALP. Thus, neither the dividend return on the shares of USco nor the expected appreciation in its shares should be considered. Canco would clearly be better off earning the expected US profits directly than merely earning AL compensation for the property and services it provides to USco. And Canco would clearly choose to run the US business itself rather than dealing with a third party US company. It is content to deal with USco because it owns all its shares. And USco has nothing whatsoever to offer to Canco. It has no other realistic alternatives.
It would thus appear that the establishment of USco and entering into transactions with it fails to meet the requirements of the FEA analysis outlined above and thus, for TP purposes, USco will be treated as a branch of Canco (and all its profits will be taxable in Canada). Is this result really intended?

At a minimum, it does violence to established Canadian tax policy. The scheme of the Canadian Income Tax Act clearly contemplates the formation of foreign subsidiaries and indeed provides exemption from Canadian corporate level tax on dividends received if sourced from foreign active business activities conducted by such a subsidiary in the US. The FEA test seems to preclude exploiting foreign business opportunities in a subsidiary. Under the current TPGs, it is permissible to permit business opportunities to be exploited by NAL parties and no compensation needs to be provided.

This example highlights the risk of importing more and more undefined imprecise principles into the determination of the ALP of transactions. It adds to the already increasing level of double taxation risk as well as to the already large expense of defending attacks by multiple tax authorities – who will surely fail to share common interpretations of these new rules.

From a Canadian perspective, although the TPGs are not law but merely guidelines to be considered, taxpayers are subject to penalties if they fail to prepare adequate contemporaneous documentation. The revenue authorities afford the TPGs much more deference than do the courts. Taxpayers will therefore most certainly be forced to prepare documentation having regard to the FEA and other new tests if they wish to avoid the risk of TP penalties being proposed or imposed. What authorities or sources are taxpayers supposed to use in determining the FEA of their transactions?

The commercial rationality test the OECD proposes to replace or enhance obviously did not meet OECD expectations. The Draft indicates in paragraph 88:
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.

Does the new FEA test will really afford greater definition to the commercial rationality test? Will we be reading about a new and improved test in a few years? If it is hard to determine what AL parties would have done while behaving in a commercially rational manner, will it really be easier to apply this new test? Merely substituting new rules for old ones per se will not make the job easier if the root of the problem is not knowing what AL parties would do.

But more fundamentally, the paragraph treats the “if you can reliably price it you don’t recharacterize it” rule of the prior TPGs as if it was an inaccurate reading of the rules. The following paragraphs from the 2010 TPGs are clear:

**Non-recognition only in exceptional cases**

9.168 Paragraphs 1.64-1.69 explicitly limit the non-recognition of the actual transaction or arrangement to exceptional cases. This indicates that the non-recognition of a transaction is not the norm but an exception to the general principle that a tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them. The word “exceptional” in this context is similar in meaning to “rare” or “unusual”. It reflects that in most cases it is expected that
the arm’s length principle under Article 9 can be satisfied by determining arm’s length pricing for the arrangement as actually undertaken and structured.

**Determining whether a transaction or arrangement has an arm’s length pricing solution**

9.180 Under the second circumstance discussed at paragraph 1.65, a second cumulative criterion is that “the actual structure practically impedes the tax administration from determining an appropriate transfer price.” If an appropriate transfer price (i.e., an arm’s length price that takes into account the comparability – including functional – analysis of both parties to the transaction or arrangement) can be arrived at in the circumstances of the case, irrespective of the fact that the transaction or arrangement may not be found between independent enterprises and that the tax administration might have doubts as to the commercial rationality of the taxpayer entering into the transaction or arrangement, the transaction or arrangement would not be disregarded under the second circumstance in paragraph 1.65. Otherwise, the tax administration may decide that this is a case for not recognising the transaction or arrangement under the second circumstance in paragraph 1.65.

Is it really necessary to remove this important oasis from the TPGs? If taxpayers are able to provide reasonably cogent evidence as to what range of prices AL parties would provide in a sale agreement, is it really cost effective and rational to nevertheless recharacterize and price the recharacterized transaction?²

**F. The Noose Gets Even Tighter**

In paragraph 90 of the Draft, the trademark owner, company S2, acquired a Trade Mark ("TM") for $400M from S1. S2 “has several employees with capability to assess, monitor and direct the use of the trademark by company S1, and costs of $10M, but has no capability to exploit the trademark”. S1 will assist it with that function. But, based on the FEA analysis, the ownership of the TM by S2 is to be ignored – despite the fact that it has employees with the capabilities noted above or that it may have third party creditors. It matters not that S2 has employees capable of performing some of the functions needed to

² It is highly doubtful, absent legislative changes, that the FEA test would be applied by Canadian courts. The statutory recharacterization test is premised on a simple inquiry as to whether AL parties would or would not enter into a transaction. And it is clearly the case in Canada that the courts cannot use economic substance to recharacterize transactions. See *Shell Canada Ltd. v. Canada*, [1999] 3 SCR 622 at para. 39.
deal with the acquisition and ownership of the property in question, it will not be respected as the owner of it unless it also has on staff the personnel required to exploit it.

There is no discussion whatsoever as to whether the services provided by S1 to S2 can be reliably priced or even if they can be obtained from third parties. Arm’s length property owners routinely hire others to do things they cannot do themselves and they rarely give all the resulting profits (above a reasonable level return) to the service provider. Warren Buffett routinely makes decisions to acquire companies and readily admits that he could not run the acquired companies. Yet he still earns a pretty good return despite that failing. This is yet another example of positions in the Draft being divorced from the ALP and providing for BEPS focused results.3

Under the Draft, the OECD is moving far beyond a regime whose purpose is to determine AL prices. The new regime routinely recharacterizes transactions even if they can be reliably priced by creating a FEA threshold rule for entry into the ALP regime. Transactions will be respected only if they meet the FEA requirements – whatever they might be.

As the example above demonstrates, there is no mention whatsoever of the collateral damage this may cause to third parties who deal with the NAL parties. The assumption seems to be that all the entities are 100% owned and there are no third parties affected.

G. Factoring – para 71 and 72 – faulty tower

The reason outlined for factoring given in paragraphs 71 and 72 is that “risk transfer is only likely to happen if the transferee is well placed or better placed to manage risk than the transferor”. The predominant commercial reason for factoring receivables is to raise money. In fact, in most securitization transactions the primary objective is to obtain a lower cost of borrowing by enhancing creditworthiness by use of a special purpose

3 And of course, the fact that there are very good commercial reasons for a corporate group putting all their TMs or other IP in one entity is of no consequence.
borrowing vehicle. The receivables factored typically have very low default and delinquency rates and factoring is merely a financing technique. In fact, the borrowers almost always continue to manage their customer receivables – albeit on behalf of the transferee. The ability of the transferee to manage the receivables is rarely a factor.\(^4\) Lenders typically do not have even matching capability in this regard.

The basic premise espoused in the Draft regarding risks is that NAL risk shifting by contract is to be ignored for transfer pricing purposes, unless the transferee is able to control the risk assumed. It is very difficult to see how this premise is supported by the factoring example for the reasons noted above.

If a corporate group decides to place all of its foreign exchange risks in one legal entity rather than leaving them in various entities around the world, and to have relevant services provided to that entity by personnel situated in one or more other group entities, regardless of whether the move is dictated by tax or business efficiency reasons or both, why should governments be able to ignore that legal reality under TP rules purportedly based on the ALP if the AL price for the services provided can be reliably determined? Why does it necessarily follow that the VC in such a case arises only from the SPF provided by the service providers even where it can be demonstrated that the ALP for those services does not accord with the result produced under the VC proposals? And if the only reason for doing so is that the prevention of BEPS requires it, then it bears restating that it makes no sense to distort the ALP with clearly erroneous principles in order to cooper up otherwise deficient tax regimes. It makes much more sense to treat the disease than the symptoms.

\(^4\) Pun intended.
H. Special Measures – Binding arbitration is a Necessary Condition

Paragraph 6 of Part II – Potential Special Measures states:

“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.”

The mere “best efforts” consideration to the avoidance of double taxation as noted in the paragraph should not be acceptable in light of the torrent of TP challenges being unleashed by the OECD BEPS project. The report on dispute resolution (Action 14) admits OECD failure to achieve consensus on binding arbitration. But that is seemingly considered a small price to pay for furthering BEPS avoidance objectives. If these VC and FEA measures are adopted and not limited in their application to situations where binding arbitration is available, double taxation will be the rule not the exception.

The costs of dealing with TP disputes can be staggering. Binding arbitration provides an essential reasonably cost-effective alternative to litigation for the resolution of most disputes in a timely manner. And even more importantly, the mere existence of that remedy has been hugely effective in making the MAP more successful. It is not nearly enough to have revenue authorities merely promise to play nicely with each other and to apply the rules fairly. If the OECD cannot deliver binding arbitration, the BEPS project will result in a regression rather than progression for TP purposes.

I. Option 3: Thick Capitalization – an unworkable solution

Option 3 (Thick Capitalization on page 42 of the Draft) seems to require revenue authorities to apply their TP rules to determine appropriate levels of capitalization for each and every company engaged in cross-border trade.
Are governments really equipped with the resources needed to carry out these assessments in a timely and competent manner? Is second guessing taxpayers through the use of hindsight really the preferred approach?

J. **Option 4: Minimal Functional Entity determination**

Option 4 on page 44 of the Draft demonstrates again that VC is not consistent with the ALP. The result is a series of judgment calls as to qualitative and quantitative attributes of an entity made by revenue authorities which results in the legal ownership of property by that entity being disregarded for TP purposes. The analysis is focused on whether personnel levels are sufficient and the functions performed routine or capital excessive, rather than whether the services provided to the entity can be valued.

VC in this example results in profits being reallocated because there is a failure to meet highly subjective undefined functional thresholds. This does not appear to have anything to do with the determination of AL terms and conditions under the ALP but rather with sham or similar determinations.

Perhaps the OECD should focus on TP and let countries focus on tax avoidance through the use of general anti-avoidance rules and other governing rules, which already have the benefit of judicial interpretation and jurisprudence. Embedding tax avoidance principles into transfer price causes chaos and a lack of focus on the TP principles.

K. **Option 5 – Ensuring Appropriate Tax of Excess Returns – the subjective “real” activities.**

Option 5 on page 45 of the Draft proposes to introduce a requirement that “real” activities be carried out within a jurisdiction before recognition is afforded. What are “real” activities? Are they the same for all businesses?

This is yet another attempt to graft sham or GAAR type rules on a pricing provision. This should be left to the non-TP provisions of the various country tax laws which were specifically created to deal with tax avoidance.
L. Conclusion – the shift from elimination of double taxation to increasing government revenues

The major concern with the Draft is that it relegates to a secondary objective the determination of AL prices under the ALP. It now seeks to fulfil a political imperative by ascribing inordinate income to SPFs using the AOA Article 7 approach without regard to the ALP.

In doing so, the Draft injects many vague and very subjective principles and terms into the already difficult TP exercise. It is destined to increase the likelihood of double taxation if adopted. Without binding arbitration as a cost-effective dispute resolution backstop, the costs of TP disputes will escalate tremendously.

The Draft indicates that:

“The BEPS Project requires an alignment between profits and value creation, and sets out the need to consider the potential for inappropriate returns for providing capital. The potential measures seek to address issues arising from the freedom MNE groups have (except in certain regulated sectors) to control their structures, including the creation and capitalisation of companies” (page 42)

As indicated by the second sentence in the above quote, there is significant concern by the OECD that the proposed measures do not have a solid foundation in the ALP. If governments are unhappy with the freedom MNEs have in establishing their offshore structures, they might consider dealing with those freedoms directly by means of controlled foreign corporation or other domestic statutory provisions that clearly limit the ability of MNEs to move assets in a tax free manner or to defer the taxation of foreign profits.

It makes no sense to torture the ALP and afford revenue authorities unfettered scope for recharacterizing otherwise valid arrangements under the guise of applying the ALP.

The Draft seeks to override established fundamental legal principles and disregards the legal form and substance of transactions with reckless abandon in order to meet the political objectives of the BEPS project. As demonstrated above, many of the new principles and
rules proposed in the Draft cannot be viewed as flowing from or being consistent with the ALP. The ALP is intended to achieve reasonable profit allocations based on the hypothetical construct of what terms and conditions the parties in question would agree to if they dealt with each other at AL. Simply put, the focus is on finding the right price (or at least a reasonable price) for a transaction — not on recharacterizing every NAL transaction and then ascribing prices to the resulting deemed transactions.

Furthermore, it seeks to inject an alternative regime seemingly without due regard to the consequences of that new regime.

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Dear Andrew

DISCUSSION DRAFT ON RISK AND RECHARACTERISATION: THE IMPORTANCE OF THE INFORMATION ENVIRONMENT

I have read the discussion draft with interest and wanted to make one brief point which I believe to be of fundamental importance in the transfer pricing analysis of risk (and indeed more generally) which receives very limited attention in the draft. This is the importance of analysing and characterising the information available to the parties; more particularly whether they have the same information about risks including their importance, how they can best be managed, and whether the party responsible for managing risks has done so appropriately.

I was prompted to make this point by the discussion of moral hazard in the box below para 133 which makes no reference to information, whereas, for example, in the Wikipedia entry for moral hazard, information is fundamental:

“Moral hazard occurs under a type of information asymmetry where the risk-taking party to a transaction knows more about its intentions than the party paying the consequences of the risk. More broadly, moral hazard occurs when the party with more information about its actions or intentions has a tendency or incentive to behave inappropriately from the perspective of the party with less information.”

So, putting this in the context of the discussion in the draft, the question of whether the risk manager and the party bearing the risk should be characterized as having the same (relevant) information is of considerable importance. If they do, there may be no moral hazard issue and the statement that “between unrelated parties it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control” would not apply. Equally, of course, if they do not have the same information, as the draft suggests, the concept of moral hazard supports...
the proposition that control and assumption of risk could be expected to be aligned.

To illustrate by reference to one of the explicit consultation points, how in the example at paragraphs 90 and 91 moral hazard implications should be taken into account under the arm’s length principle, if S2 is well informed and its contract with S1 is structured appropriately, it might not be the case, as paragraph 91 asserts, that:

“Company S2 has no practical safeguards and is dependent on S1 to act appropriately to enhance and protect its asset through the marketing functions it undertakes, and S2 itself does not direct the way in which it can optimise returns on its asset. Compared to S1, Company S2 has less capability to manage and control the marketing which will affect the generation of expected income streams, and Company S2 has not enhanced or protected its commercial position but may have damaged it by not managing the risks in order to achieve a return on its investment in the asset.”

The reference to information that I noted in the draft (the last sentence of 67) is consistent with my point:

“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.”

While, the introduction of the information environment adds to the complexity of the functional analysis, and qualifies some of the generalisations in the draft, I don’t think it alters the analysis more fundamentally.

And I think examination of the information environment is helpful in other contexts. For example, I think information asymmetry is potentially an important reason for the existence of local market intangibles.

I would be very happy to develop these thoughts further if that would be helpful.

Yours sincerely

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OECD
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By e-mail

BEPS Actions 8, 9 and 10: Discussion Draft on revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterization and Special Measures)

Dear Mr. Hickman,

Please find below the comments of RBS RoeverBroennerSusat GmbH & Co. KG Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft ("RBS RoeverBroennerSusat") on the public discussion draft regarding "BEPS Actions 8, 9 and 10: Discussion Draft on revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterization and Special Matters)" issued on 19 December 2014 ("OECD Discussion Draft"). RBS RoeverBroennerSusat acts as a tax advisor and an auditor of the small and medium sized entities ("SME") as part of the German mid cap market (Mittelstand). Thus, the focus of our comments is set on the impact of the OECD Discussion Draft on SMEs as part of the German mid cap market.
A. Part I

RBS RoeverBroennerSusat broadly supports the aim of the OECD to ensure that transfer pricing outcomes are in line with value creation. Providing further guidance on determining the economically relevant characteristics or comparability factors of controlled transactions is a commendable contribution towards realizing this aim. Refining the OECD Guidelines will contribute to strengthening the consensus of the arm’s length principle and to strengthening its status as the international standard. Ensuring that the separate entity approach more adequately considers the effects of the increasingly integrated nature of business models may reduce incentives for national taxation jurisdictions to adopt non-arm’s length approaches (formulary apportionment). The adoption of non-arm’s length approaches would in turn increase uncertainty in respect to determining transfer prices and thus could lead to higher risks of double taxation.

However, we find it worthwhile to point out that the revisions proposed in the OECD Discussion Draft are likely to result in requiring a more complex and holistic approach in conducting the comparability analyses. While this follows logically from the aim of refining the separate entity approach, it appears sensible to ensure that additional requirements for taxpayers are confined to cases in which integrated business models have a significant impact on transfer pricing outcomes. As also pointed out in our comments on “BEPS Action 10: Proposed Discussion Draft on the use of Profit Splits in the context of global value chains”, we consider it essential to avoid unintended consequences, such as a curtailment of applying one-sided transfer pricing methods. The emphasis on the need to take into account how functions relate to the wider generation of value by the MNE group as a whole (e.g. D.1.10 or D.1.1.16 – the modification of 1.42) results in stricter comparability requirements. In turn the number of comparable transactions will be reduced and will make it more difficult to apply one-sided methods. As a result, taxpayers could face increased costs relating to conducting and documenting comparability analyses as well as to fostering additional uncertainty during tax audits. In Germany (pursuant to Section 4 No. 3 (b) GAufzV) taxpayers are required to describe the entire value chain including the taxpayer’s contribution thereto. As clarified by the Administrative Principles - Procedure (Verwaltungsgrundsätze-Verfahren), the taxpayer’s contribution to the value chain can, however, be regularly deduced from the functional and risk analysis and the corresponding economic analysis. Hence, particularly when analyzing routine functions, it is generally not required to conduct a separate value chain analysis and to prepare respective documentation. Integrating similar provisions into the OECD Discussion Draft, including explicit references to the proposed modifications to Chapter VII (relating to low value-adding intra-group services, specifically the applicability of the simplified benefit test) appears sensible. Respective provisions should ensure that the administrative burden involved in compiling transfer pricing documentation is, particularly for SMEs, minimized.

Additional Points:
Moral hazard and Risk-return trade-off

1. Moral hazard should be taken into account under the arm’s length principle. It would, however, appear questionable to deny recognition of a specific transaction for transfer pricing purposes solely on the grounds that the assumption and the management of a particular risk are misaligned. In situations, such as described in paragraph 62 of the
OECD Discussion Draft, the impact of a misalignment should be assumed to be negligible. Particularly in the case of the distributor being classified as a routine entity and receiving remuneration based on full costs, a need for additional contractual safeguards would not arise.

2. ./.

3. The impact of moral hazard given in the example in paragraphs 90 and 91 should not be overestimated. The nature of the transactions suggests a mutual dependence of the two parties S1 depending on S2 being willing to license the trademark and S2 depending on S1 to protect the asset through performing marketing functions. In a comparable transaction between independent parties, moral hazard would be limited by such a mutual dependency (with cooperation being beneficial to both parties in a game theoretical sense). Contractual provisions could further reduce moral hazard (e.g. a long duration, as well as exclusivity and buy-back clauses for S1 plus minimum royalty payments and penalty clauses to benefit S2). In order to determine whether the transaction lacks the fundamental economic attributes of an arrangement between unrelated parties a more detailed analysis of the relevant facts and circumstances would be required, including the relevant risk-return trade-off (see below). A respective analysis should be mandatory prior to denying recognition of any transaction for transfer pricing purposes, which should be considered as a method of last resort (which is our interpretation of paragraph 84). The burden of proof should remain with the tax authorities. In order to clarify these important issues, additional guidance would be highly appreciated.

4. Yes, provided the provisions in paragraph 89 (risk adjusted commercial positions) are observed.

5. Transfer of risks from S1 to S2 (extent would depend on contractual provisions, see above).

6. Risk-return trade-off should be considered by evaluating whether the lower anticipated nominal income of S1 is adequately compensated by reduced risk (commercial rationality test, applying DCF methods as well as prospect and game theoretical considerations).

7. In case risk-return trade-offs are commensurated with a respective commercial rationality test, we do not see much room for any opportunistic application. The extent of profit-shifting (BEPS) by “manipulating” the discount rates would be limited, as these would have to be substantiated in the context of the commercial rationality test. Taxpayers should not be required to produce additional proof of the economic rationality of respective transactions. At this time any additional documentation requirements, particularly for SMEs, appear disproportionate. In this context we would like to refer to our comments on BEPS Action 11.

8. ./.

B. Part II

Potential special measures

Prior to adopting special measures, the OECD should facilitate the quantification of the residual BEPS risk, i.e. the anticipated risks remaining after the proposed revisions to the OECD Guidelines have been implemented. The adoption of special measures should generally be targeted at clearly identified risks. Respective trade-offs in terms of an additional compliance burden for
taxpayers as well as an increased risk of double taxation must be carefully assessed. In this context it would appear sensible to subject special measures to an impact assessment procedure. Furthermore, thresholds for applications of measures should adequately take potentially disproportionate administrative burdens for SMEs into account. Respective trade-offs between minimizing BEPS and additional compliance burdens for SMEs will most likely favor comparatively high thresholds and thus limit application of special measures to MNEs (respective analysis should be conducted in the context of BEPS Action 11).

In order to strengthen the consensus of the arm’s length principle and its status as the global transfer pricing standard, it would appear prudent, even at this stage, to devote attention to differentiating between special measures that within the arm’s length principle and those measures that go beyond the arm’s length principle. Special measures exceeding the arm’s length principle of the OECD Guidelines, should remain separate from the OECD Guidelines and their scope of application should be limited to clearly defined circumstances as well as high thresholds (please refer to our comments on Action 4 for respective comments in regard to interest deductions).

**Hard-to-value intangibles**
The proposed special measures relating to HTVI appear sensible and are in line with the arm’s length principle. When transactions are subject to a high degree of uncertainty, price adjustment mechanisms generally can be assumed to reflect arm’s length behaviour. The discretion of tax authorities to presume that respective mechanisms would have been agreed upon between unrelated parties and to rebase related calculations should, however, be limited to cases where transfer pricing outcomes are clearly not in line with value creation. The burden of proof must remain with the tax authorities and should not be reversed due to a lack of contemporaneous documentation by the taxpayer. Furthermore, a safe harbor similar to that outlined in the Discussion Draft (last bullet point on page 41) should be observed.

**Independent investor / Thick capitalization**
These special measures generally exceed the arm’s length principle and should be subjected to a respective impact assessment (see above). In evaluating the respective trade-offs, these special measures would arguably be evaluated as rather effective in terms of reducing BEPS risks. It would further appear feasible to stipulate high thresholds (e.g. € 50,000,000 annual turnover at group level) without significantly limiting the effectiveness of the measure (establishing sensible thresholds should be a mandatory element of the impact assessment).

**Minimal functional entity**
Considering that respective BEPS risks are efficiently targeted in the context of Action 8 as well as by the proposed special measures on HTVI (see above), any additional special measures targeting transfer pricing structures or BEPS behaviour based on minimal functional entities appear to be redundant at this point in time.

**Ensuring appropriate taxation of excess returns**
See comments on Independent Investor / Thick capitalization (above)
We remain at your disposal for any further discussion of these issues.

Yours sincerely,

RBS RoeverBroennerSusat GmbH & Co. KG
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

Gertrud R. Bergmann
Diplom-Kauffrau
Wirtschaftsprüfer
Steuerberater
Partner

Marcus von Goldacker
Diplom-Kaufmann
MBA (International Taxation)
Steuerberater
Partner
Dear Mr. Hickman,

We appreciate everything that Working Party No. 6 (WP6) has achieved on all its transfer pricing endeavours. On behalf of RSM International Limited, we respectfully submit for your consideration, general observations, and specific responses to comments requested on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures).

Our comments are as follows:

Part I, Chapter I, Section D of the Transfer Pricing Guidelines

Overall, we agree with the proposed changes to Chapter I, Section D of the Transfer Pricing Guidelines. We believe that most of it is a logical and inevitable extension to the work done in the field of intangibles. In this regard, we refer especially to the comments included in Section D2 regarding control over risk and moral hazard. We generally agree with the notion that between unrelated parties risks tend to be allocated to the parties that have relatively more control over such risks. In this regard, we recommend allowing for exceptions where taxpayers or tax administrations are allowed to demonstrate that in specific situations, third parties are willing to absorb a relatively large portion of risk, despite exercising little control over such risks.

D.1 Identifying the commercial or financial relations, paragraph 12

The discussion in paragraph 12 could benefit by referencing business strategies pursued by an enterprise (mentioned in paragraph 10). For example, it is common for an enterprise to sell products to an independent third party at a lower price even when other potential customers are willing to pay more under similar conditions, or are willing to pay the same price under more beneficial terms and trade conditions, as a strategy to gain a new customer/distributor in an important sector or territory. In addition
to the comparability considerations discussed therein, we suggest an explicit mention in this paragraph about the considerations for market penetration strategies or other long term business objectives in evaluating the terms of a potential transaction.

D.1.4 Business Strategies, paragraph 35

We agree that tax administrations may wish, rather should, consider evidence of the commercial strategies evident in the country in which the business strategy is being pursued, in determining what period of time an independent enterprise would accept to conclusively determine their outcome. However, various “rules-of-thumb” for establishing periods of time are seen in practice, e.g., three-years, etc. We welcome the OECDs comments on said practices.

D.4 Non-Recognition, paragraphs 83-84

We agree with the OECD's caveats on non-recognition, and encourage the OECD to expand on this section to include unambiguous parameters and examples as to when this approach can be invoked.

Questions Raised

In response to questions 4-7 (pp.14-15), it is our view that transactions between associated enterprises from which the sole effect is to transfer risk should in principle, be recognized.

Under the at arm's length principle, the purpose of the transaction (whether it is to create BEPS or not) should not be decisive. The key question remains whether independent third parties would have entered into the transaction. In this respect, the risk-return trade-off is essential.

This also applies in transactions where the sole effect is to shift risk. Disallowing arguments based on the risk-return trade-off merely because the respective transaction creates BEPS does not reflect the arm's length principle. The proposed additions to the arm's length principle offer sufficient safeguards against such transactions with reference to concepts as "options realistically available" and "control over risk."

Paragraphs 90 - 92

We generally agree with the proposals made in this section. We believe that the OECD's assessment of the outcome of the example of paragraph D.4.2, point 90 through point 92 is somewhat premature. Particularly, the following factors have not been considered:

1. The bargaining power and options realistically available to Company S1.
2. The purchase price paid by Company S2 in relation to the value of the IP for Company S1 taking into account the cash flows generated (e.g., using a DCF method).

Depending on these aspects which have not been considered, it is possible that independent third parties would have entered into the transaction.

In respect of point 1, a dire financial situation or insufficient funds to further develop the IP of company S1 could be reasons to transfer the IP to Company S2.

Regarding point 2, we believe many third parties would be willing to sell the IP for a lump sum amount if that amount exceeds the anticipated discounted value of the cash flows related to that IP. Reasons for Company S2 to offer an amount higher than the discounted cash flow of the IP to company S1 could include the possibility for Company S2 to exploit the IP in new territories (e.g., by licensing the IP to other group companies or third parties) and to make significant investments in marketing etc. Company S1 may not have had the options realistically available to do this (e.g., due to insufficient cash flows, etc.).
Assuming that S2’s country’s legal framework and capability to provide trademark protection is true, it is possible that the intangible asset is better placed in S2.

In conclusion, we feel that the example does not weigh all the relevant factors attributable to the transactions, but rather the example skims through selected arguments that could be offset with legitimate business considerations. In case the IP concerned a “hard to value intangible,” we agree it is suitable for the arm's length principle to provide for the use of a contingent purchase price as proposed in Option 1 of Part II.

**Part II, Potential Special Measures**

Option 1: Hard-to-value intangibles ("HTVI")

We agree with the proposed measure. This measure will help ensure that the transferor receives an arm’s length price for the intangibles sold even where the price was difficult to determine at the moment of sale.

The main benefits of this option are in our view:

1. This option fits within the arm's length principle
2. It has been a tried and tested measure in some OECD countries
3. The effect of this measure is likely a behavioural change which will ensure alignment of transfer pricing outcomes and value creation
4. It is a targeted measure which may result in less “overkill” in relation to a valuation approach
5. This measure does not create an excessive compliance burden for both taxpayers and tax administrations (in contrast with some of the other suggestions)
6. This option has less potential to result in double taxation than some of the other options

We do not see any disadvantages in adopting this measure, and will welcome further guidance with regard to determining the pricing of the contingent payments. In our view, this measure could become an integral part of transfer pricing principles.

Option 3: Thick capitalization

We are of the view that Option 3 does not reflect the arm’s length principle as the OECD in the Guidelines currently describes it, nor as it is reflected in the recent reports on BEPS.

It makes sense economically to allocate more equity to high-risk entities (such as an IP owner or full fledged manufacturer) compared to low risk entities (such as a Shared Service Center). Disregarding this settled economic principle by applying a fixed debt-to-equity ratio or group ratio departs from the arm’s length principle. Therefore, this measure is more likely to increase the gap between transfer pricing outcomes and value creation rather than re-align them.

Implementing a thick capitalization principle in an economically rational manner would include guidance on how to allocate debt and equity to various group companies taking into account the aforementioned economic principle. This does, however, require customized approaches for each group company. In our view this creates an excessive administrative burden to both taxpayers and tax administrations. There
are in our view sufficient other manners to deal with BEPS without focusing on the debt or equity funding of companies.

Option 4: Minimal functional entity

If implemented in such a manner that this measure fits within the arm’s length principle, we believe this measure could contribute to an effective and economically rational re-alignment of transfer pricing outcomes and value creation.

It would be a practical solution to determine an arm’s length price for a transaction where one party performs minimal functions by defining a minimal function threshold on the basis of qualitative attributes. We note the following:

1. Quantitative aspects should cautiously be used as a threshold to determine whether or not an entity has minimal functionality, as they often do not reflect the concrete situation of the company (e.g., only few staff are required for a specific function) and depart from the arm’s length principle. In line with the previous work on intangibles, we believe that qualitative aspects such as the capacity (taking to mean the ability to control the risks, functions and assets) of an entity should be the basis upon which profits are, in accordance with the arm’s length principle, attributed to the various entities within an MNE group.

2. A fixed pre-determined factor on the basis of which a mandatory profit split would be applied is not advisable, as we feel that a profit split should be customized to the specific functions, assets, risks employed within the various group companies, along with consideration of options realistically available and bargaining power.

3. The foregoing applies even more with respect to the proposed re-allocation of profits to the immediate parent or to the company providing functional capacity. This may lead to inconsistencies with other proposals with respect to intangibles and profit splits.

Option 5: Ensuring appropriate taxation of excess returns

Due to a lack of focus on artificial arrangements, it is our view that this option (in its current form) encroaches too much upon the sovereignty of states to determine their own tax rates. The measure has the potential to discriminate against investments in genuine operational businesses merely because that business is established in a low-tax jurisdiction. The sole fact that a jurisdiction intends to attract businesses by having a low corporate tax rate should not give another jurisdiction the authority to tax the profits of the other jurisdiction’s businesses.

Preferential tax treatments provided by a jurisdiction in form of tax holiday, reduced tax rate, etc., should be considered in determining the “x% threshold.” It could be interpreted as a location savings matter.

The secondary rule would lead to implementation challenges given that it would be difficult to determine which jurisdiction (apart from the parent entity jurisdiction) has taxing rights.

It is not sufficient to apply a CFC rule merely due to the fact that the CFC is low-taxed. As required by most existing CFC rules around the world, in addition to being low-taxed, the CFC’s business should be dependent on easily movable assets (“passive assets”) in order for the CFC rule to apply. CFC rules have the potential of significantly limiting BEPS.
We thank you for the opportunity to provide our input and look forward to participating in upcoming consultations. Should you have any questions on our comments, please contact Dr. Enrique Rayon at +1 949 255 6500 or Enrique.Rayon@McGladrey.com.

Yours sincerely,

On behalf of the RSM International Transfer Pricing Group

Aaron Kindich, Germany
Victor Bussche, Germany
Anja Guenther, Germany
Thomas Luebbehuesen, Germany
Dicky To, Hong Kong
Michael Bolt, The Netherlands
Fons Ravelli, The Netherlands
Mario van den Broek, The Netherlands
Jignasha Voralia, United States
Brenda Henriquez, United States
Tansy Jefferies, United States
Mark Kral, United States
Enrique Rayon, United States

Transfer Pricing within RSM International

The RSM International network has a presence in over 112 countries around the world with 37,000 people serving the needs of their clients.
Dear Mr. Hickman,

Ryan Netherlands B.V. (hereinafter referred to as “Ryan”) is pleased to comment on the BEPS Action 8, 9 and 10: “Public Discussion Draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, re-characterisation, and special measures)” (hereinafter referred to as “discussion draft” or “draft”).

First of all, Ryan is enthusiastic on the discussion draft as it provides new guidance on various topics related to application of the arm’s length principle within multinational enterprises. The practical examples and illustrations are useful and can be referred to when dealing with concrete issues. We support the OECD’s leadership efforts to promote and maintain a broad international consensus on transfer pricing issues related to low value-adding services and are convinced the discussion draft is a step forward in this matter.

Our comments on the discussion draft are as follows:

Comparability & adjustments (§14 & §22) - The discussion draft (re-)emphasises the importance of comparability. Considerable attention is made to highlight the importance of performing comparability adjustments to improve reliability (§14). Ryan believes that the current revision is a good opportunity to introduce more guidance on the term “improve reliability”. In performing its advisory work, Ryan is often confronted with a lack of comparability. When trying to determine an appropriate adjustment, Ryan is confronted with the following challenges:

- A lack of guidance on how to apply adjustments;
- Lack of comparable, publically available data to support the adjustment;
- Difficulty in assessing whether the adjustment “improves reliability”;
- As a result of the above, potential risks that tax authorities may challenge the adjustments performed.

Ryan would welcome additional wording on how to determine whether adjustments improve reliability.

**How to assess whether data is “reliable” (§26)** - From our experience and past observations, comparability analysis depends on the availability of publically available data. In Europe, the availability of private data makes it possible to focus on both product and functional similarity. This is often not possible in the United States and Asia (due to the limited amount of available potential comparables as a result of the requirements or preference for a comparability analysis to be performed solely on public listed company data instead of private company data). Although the comparability analysis is more precise in Europe, the comparable companies’ identified often lack consistent financial data at gross profit level. This makes it challenging to apply methods based on gross profit indicators. More wording would be welcomed on how to deal with situations where reliability of comparables is strong but reliability of financial data is weak and vice versa.

**Relevance of shareholder ownership when assessing economically relevant characteristics (§10)** – The discussion draft provides further details on economically relevant characteristics that need to be identified. Ryan believes shareholder ownership should be included as one of the factors that need to be identified. Many countries have local regulations on how to define related entities. Often, a shareholder ownership of 10% is already sufficient to qualify as related entity. Although selecting a low percentage is understandable from a regulatory perspective, from an economic perspective, a low percentage typically reflects a low level of influence. In a situation where related parties are not 100% related (for example in a joint venture), a shareholder ownership analysis can be relevant to assess to what extent there is a natural interest to act at arm’s length. More wording on this topic would be welcomed.

**Moral Hazard** – the introduction of “moral hazard” in the transfer pricing discussion is complex. Ryan believes that any guidance has to be introduced with great care. It is tempting to introduce various scenarios and examples where moral hazard could play a role in the allocation of profit. Nevertheless, Ryan believes that guidance on this topic may raise more questions than it solves and introduce great uncertainty at the level of the corporates who will have to deal with this. In this context, we would welcome the introduction of wording emphasising that the moral hazard topic is a complex topic that should be addressed with great care by tax authorities.

**Risk-return trade-off** – The discussion draft further elaborates on the complexity of risks in trying to determine an arm’s length allocation of profit. Ryan believes the discussion draft provides an opportunity not only to discuss the complex aspects of risks but also to discuss “routine risks”. With routine risks we refer to risks that can be shifted and managed easily and where the financial impact in the event the risk would materialise is relatively limited. A discussion on routine risks could introduce a “safe harbour” on risks and provide some form of certainty to corporates when it comes to routine risks.

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1 Where moral hazard refers to the lack of incentive to guard against risk where one is protected from its consequences.
Financial Services Sector – In response to question 8, Ryan believes separate guidance on risk is required for the financial services sector. In comparison to corporates, risk in the financial sector is something that can be shifted with the “press of a button”. By simply selling or buying stock in large quantities, the risk position of an entity can be changed dramatically. Where corporates perceive risk as a something to manage over time, a financial institution could theoretically adjust its risk profile overnight.

How to apply adjustments where a lack of comparability is identified (§75) – In the discussion draft, the comparability analysis is taken to a more detailed level. When assessing comparability of risks, Ryan agrees it is relevant to determine whether the potential comparables identified comprise the same level of risk or same management of risks as the tested party. However the application of an appropriate adjustment to address potential mismatches can prove to be challenging. Information on risks incurred is typically not available in publicly available databases. In order to perform a detailed comparability analysis on risks, contractual obligations and/or actual conduct of the potential comparables need to be reviewed. Such information is typically not available. More wording would be welcomed on how to deal with such a lack of data.

Ryan is pleased to provide these comments to contribute to the further development of the proposed revisions to Chapter I of the Transfer Pricing Guidelines including risk, re-characterisation, and special measures.

Yours sincerely,

Roderick Veldhuizen

On behalf of Ryan Netherlands
February 6, 2015

VIA E-MAIL

Mr. 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

Re:  Comment letter on the OECD 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)

Dear Mr. Hickman,

These comments are submitted by the undersigned independent trade associations, described in Appendix A and B, which together include over 100 companies as members, in response to the invitation to submit comments 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), issued December 1, 2014.

Respectfully submitted,

Silicon Valley Tax Directors Group (SVTDG)  
www.svtdg.org

TechNet  
www.technet.org
Executive Summary

I. Summary of comments on sections of Part I dealing with risk, and with non-recognition of associated enterprise transactions, in the context of the ALP

The TPG are constrained by the arm’s length principle (“ALP”), the authoritative statement of which is found in Article 9, ¶ 1 of the OECD Model Tax Convention. The ALP in particular constrains the proposed changes, in the BEPS ACTIONS 8, 9 AND 10 DISCUSSION DRAFT ON REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (“Actions 8–10 PDD”), to § I.D of the TPG relating to risk and possible non-recognition of associated enterprise transactions.

The ALP allows a tax administration to price associated enterprise transactions consistently with prescribed behavior of independent enterprises. By its terms the ALP first requires—when evaluating a particular associated enterprise commercial relation—one to hypothesize independent enterprises entering into the same commercial relationship, performing the same activities and having comparable assets. The associated enterprises in the commercial relation will generally be exposed to extrinsic risks, but they may not be exposed to moral hazard risks to the same extent as are independent enterprises. Applying the ALP further requires hypothesizing the independent enterprises being exposed to the same extrinsic risks as are the associated enterprises, and that the independent enterprises also choose the same contract terms and allocation of extrinsic risks as chosen by the associated enterprises. The specific payment terms such independent enterprises would agree upon would reflect both any risks imputed from the associated enterprise commercial relation and also any additional moral hazard risks arising from the imputed contract provisions and allocations of extrinsic risk. Under the ALP, the associated enterprises must price their commercial relation the same way—i.e., the payment terms incorporate compensation for both extrinsic risks they bear and also any moral hazard risks the associated enterprises mightn’t actually bear (or bear only to a much smaller degree). The ALP is accordingly concerned with pricing associated enterprise transactions. This pricing can be gotten either through observations of independent enterprise behavior (comparables) or by determining pricing through methods not relying on comparables (including, e.g., profit splits).

This understanding of how the ALP—which incorporates extrinsic and moral hazard risks to yield arm’s length pricing of associated enterprise transactions using hypothesized behavior of independent enterprises—allows one readily to answer questions posed in the Actions 8–10 PDD relating to moral hazard and risk-return trade-off.

Proper application of the ALP requires a tax administration to recharacterize the form of an associated enterprise commercial relation if that form doesn’t mirror the economic substance.
If the economic substance mirrors the form, no other recharacterization is needed or in fact permitted under the ALP.

The confusing, alternative, two-pronged test for recharacterization of associated enterprise transactions in ¶ 1.65 of the TPG isn’t justified by the ALP. In nominally trying to give “greater definition” to the alternative test, the Actions 8–10 PDD applies questionable reasoning and arrives at a new “fundamental economic attributes” test which would allow a tax administration to disregard an associated enterprise transaction if the test is failed. The fundamental economic attributes test in essence permits disregard of such a transaction if it’s not likely to be observed among independent enterprises. This test is thus inconsistent with the ALP, which doesn’t try to conform associated enterprise behavior to that of independent enterprises, but rather seeks just to price associated enterprise transactions based on hypothesized behavior of independent enterprises, using transfer pricing methods based on comparables or otherwise. The fundamental economic attributes test must thus be rejected.

The facts of the trademark transfer example in ¶¶ 90–91 of the Actions 8–10 PDD are contrived to try to show a situation failing the fundamental economic attributes test. Proper economic analysis of the facts demonstrates the opposite (even assuming the test is justified, which it isn’t). The facts in the example are, moreover, not consistent with typical transfers (among independent or associated enterprises) that would be trademark law best practices.

II. Summary of comments on Part II dealing with special measures

The special measures in Options 1 (HTVI) and the primary rule in Option 5 (taxation of excess returns) warrant further consideration and could, if suitably modified, form practicable BEPS tools for WP-6 to endorse. Option 1 should be modified so as to be subject to the ALP, enabling taxpayers to avoid ex post adjustments based on actual outcomes by proffering evidence of comparable independent enterprise transactions. The primary rule in Option 5 operates like a CFC rule, in which the ultimate parent can tax “excess returns” of a CFC if it’s subject to a three-year average effective tax rate lower than some threshold. The primary rule should apply after application of the normal transfer pricing rules, and will ensure a baseline level of taxation of most income currently subject to BEPS concerns. The secondary rule in Option 5 should be rejected for a number of reasons, including uncertainty about which “other jurisdictions” could be allocated taxing rights over “excess returns,” and the unlikelihood of getting agreement on what “pre-determined rule” for allocation would be used.

The special measures in Options 2–4 should be rejected. Each such Option is arbitrary, impracticable, and/or subjective, and would lead to protracted disputes unlikely to be resolved. There is no generally agreed upon optimal level of capitalization, making Options 2 & 3
arbitrary. Option 4—dealing with minimal functional entities—is in effect an end-run around application of normal transfer pricing rules under the ALP (including revised TPG Chapter VI).
I. Introduction and summary

We thank Working Party No. 6 ("WP-6") for preparing 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 ("Actions 8–10 PDD") and for asking interested parties to give written comments. In this letter we comment on three aspects of the Actions 8–10 PDD: (1) the proposed changes to § I.D.2 of the TPG—in particular, the additional points and questions relating to moral hazard risks and risk-return trade-offs; (2) the proposed changes to § I.D.4 of the TPG relating to non-recognition of associated enterprise transactions; and (3) the proposed special measures in Part II of Actions 8–10 PDD.

A. Summary of comments on Part I of the Actions 8–10 PDD, proposing changes to § I.D. of the TPG

1. Summary of comments on § I.D.2 of the TPG—identifying risks

The questions in the Actions 8–10 PDD relating to moral hazard risk and risk-return trade-off can best be answered by reviewing how the arm’s length principle ("ALP") in Article 9, ¶ 1 of the MTC works in the context of risk. The ALP is concerned with pricing associated enterprise transactions consistently with prescribed behavior of independent enterprises. When evaluating a particular associated enterprise commercial relation, the ALP first requires one to hypothesize that independent enterprises enter into the same commercial relationship, performing the same activities and having comparable assets. The associated enterprises in the commercial relation will generally be exposed to extrinsic risks, but they may not be exposed to moral hazard risks to the same extent as are independent enterprises. Applying the ALP further requires hypothesizing the independent enterprises being exposed to the same extrinsic risks as are the associated enterprises, and that the independent enterprises also choose the same contract
terms (assuming the contract terms are consistent with the economic substance of the associated enterprise transaction) and allocation of extrinsic risks as chosen by the associated enterprises.

The specific payment terms such independent enterprises would agree upon would reflect both any extrinsic risks imputed from the associated enterprise commercial relation and also any moral hazard risks arising from the imputed contract provisions and allocations of extrinsic risk. Under the ALP, the associated enterprises must price their commercial relation the same way—i.e., the payment terms incorporate compensation for both extrinsic risks they bear and also any moral hazard risks the associated enterprises mightn’t actually bear (or bear only to a much smaller degree). This pricing of associated enterprise transactions can, under the ALP, come either through observations of independent enterprise behavior (comparables) or by determining pricing through methods not relying on comparables (including, e.g., TNMM, profit splits, etc.).

In response to the questions relating to moral hazard and risk-return trade-off: (1) arm’s length payments between associated enterprises will generally reflect moral hazard risks arising among independent enterprises operating under the same commercial relationships under similar contractual provisions and comparable allocations of extrinsic risk, but this doesn’t mean such moral hazard risks and the corresponding contractual incentives/penalties are being imputed to the associated enterprises; (2) the observation in ¶ 67 of the Actions 8–10 PDD that unrelated parties may be unwilling to share insights about core competencies for fear of losing IP or market opportunities is generally not accurate—agreements and behaviors between independent enterprises allow flows of proprietary information among such enterprises while preventing misuse of such information; (3) the assertion in the example in ¶¶ 90–91 that the conditions of sale of the trademark would create moral hazards so acute that such a sale wouldn’t be economically rational if the transferor (S1) and transferee (S2) were independent enterprises isn’t
justified; (4) pure risk shifting transactions among associated enterprises can arise among associated enterprises and—assuming the economic substance of such transactions mirrors the form—such transactions should be respected; and (5) the trademark transfer in the example in ¶¶ 90–91 likely reduces S1’s exposure, but increases S2’s exposure, to risks of the business in which the trademark is used, but S2 may for various reasons be better-positioned to bear such risk, in which case S2 would value the trademark more highly than would S1; and (6) the risk-return trade-off principle is consistent with the choices of both S2 (which assumes the risk of the trademark’s income (royalties) in exchange for an expected return that includes a risk-premium commensurate with the risks incorporated in the trademark’s expected income stream) and S1 (which accepts a lump sum by and gives up the risk-adjusted expected return on the trademark’s future income in exchange for not bearing the risks of the trademark).

2. **Summary of comments on § I.D.4 of the TPG—recharacterization**

If circumstances are such that the economic substance of a transaction among associated enterprises doesn’t mirror its form then for purposes of applying the ALP to find a transfer price the transaction must be recharacterized. Authority to recharacterize transactions for tax purposes exists in the tax laws of many jurisdictions, and its reach is broader than transfer pricing, but recharacterization in such circumstances is needed for proper application of the ALP, which can only work sensibly if hypothetical independent enterprises undertake what is in economic substance the nominal transaction at issue among associated enterprises.

No other grounds for recharacterization of associated enterprise transactions are needed for proper application of the ALP, and the ALP by its terms doesn’t permit recharacterization in any other circumstances. Proper application of the ALP requires determining a transfer price assuming independent enterprises undertake the same commercial arrangement (in economic
substance) as that among associated enterprises, imputing the same extrinsic risks and taking into account moral hazard risks that arise. The pricing determination required under the ALP can sometimes be done by resort to observable behavior among independent enterprises (comparables), or failing that, other methods (such as TNMM, profit split methods, etc.) may be used. But there’s no indication in the ALP itself that the process should collapse if either observable comparable independent enterprise behavior can’t be found, or if in that event the determination is challenging. The TPG nonetheless introduced a second ground for recharacterization, based on whether “the arrangements made in relation to the transaction, viewed in their totality, [(1)] differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and [(2)] the actual structure practically impedes the tax administration from determining an appropriate transfer price.”\(^1\) The Actions 8–10 PDD tries to give “greater definition” to this opaque test. This “greater definition” comes in essence from asserting requirement (2) to be redundant if requirement (1) is met, then recasting requirement (1) by asking whether the associated enterprise transaction exhibits “the fundamental economic attributes” of arrangements between unrelated parties, and then finally asserting that such an arrangement “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.”\(^2\) The Actions 8–10 PDD thereby in effect would allow recharacterization of any associated enterprise transaction that would be unlikely to be observed among independent enterprises. This is contrary to the ALP, which requires finding a transfer price for an associated

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1. TPG, ¶ 1.65.
2. Actions 8–10 PDD, ¶ 89.
enterprise transaction using either observable independent enterprise behavior in a comparable transaction or, if not observable, calculating a price based on hypothesized behavior. The ALP wasn’t intended to restrict the transactional behavior of associated enterprises to that observed among independent enterprises. The Actions 8–10 PDD incorrectly equates lack of observable independent enterprise transactions with inability to solve a hypothetical economics problem.

The tack taken by the Actions 8–10 PDD with respect to recharacterization arguably misinterprets the ALP in Article 9, ¶ 1 to give tax administrations authority to rewrite associated enterprise transactions unlikely to be observed among independent enterprises. Because it is not grounded in the ALP, the PDD’s approach to recharacterization must be rejected.

The associated enterprise trademark transfer example in the Actions 8–10 PDD contrived to try to show application of the “fundamental economic attributes” test has questionable economic analysis in places and has confusing facts that under trademark law best practices and the law of several jurisdictions may invalidate trademark ownership. Correcting the analysis, aligning the facts consistent with trademark law best practices (i.e., the transferee must conduct core trademark functions), and assuming the economic substance of the arrangement between transferor and transferee mirrors its form, yields different results than those in the Actions 8–10 PDD (although the “fundamental economic attributes” test should in any event be rejected).

B. Summary of comments on Part II of the Actions 8–10 PDD, proposing special measures

The special measures in Options 1 (HTVI) and the primary rule in Option 5 (taxation of excess returns) warrant further consideration and could, if suitably modified, form practicable BEPS tools for WP-6 to endorse.
Option 1 should be modified so as to be subject to the ALP: taxpayers could thus avoid \textit{ex post} adjustments based on actual outcomes by proffering evidence of comparable independent enterprise transactions. Making the special measure subject to the ALP mitigates risks of double taxation. Conditioning application of the special measure on lack of contemporaneous documentation encourages taxpayers to create robust contemporaneous economic analysis in support of their transfer pricing.

The primary rule in Option 5 operates like a CFC rule, in which the ultimate parent can tax “excess returns” of a CFC if it’s subject to a three-year average effective tax rate lower than some threshold. The primary rule should apply after application of the normal transfer pricing rules (and after the impact of any local country taxes, withholding taxes, and any other gross income inclusion under a CFC regime with respect to that CFC, to determine effective tax rate), and will ensure a baseline level of taxation of most income currently subject to BEPS concerns. This work should be coordinated with that on Action 3 (strengthen CFC rules). The secondary rule in Option 5 should be rejected. It clearly is not consistent with the ALP. Only the ultimate parent jurisdiction, as location of the ultimate owner of a multinational group, has primacy of right in taxing “excess returns” of a CFC. The parent jurisdiction’s deferral of its sovereign right to tax deemed income inclusions to a resident parent company of a CFC with excess returns shouldn’t create a free-for-all allocating rights to tax such excess returns to “other jurisdictions”, whatever those jurisdictions might be. In the secondary rule, it’s unlikely that the unspecified “pre-determined rule” for allocating taxing jurisdiction over an arbitrary CFC’s excess returns would ever be the subject of agreement among jurisdictions. It’s equally unclear how double (or multiple) taxation could be avoided. The secondary rule special measure in Option 5 should accordingly be rejected.
The special measures in Options 2–4 should be rejected. Each such Option is arbitrary, impracticable, and/or subjective, and would lead to protracted disputes unlikely to be resolved. There is no generally agreed upon optimal level of capitalization, making Options 2 & 3 arbitrary. Option 4—dealing with minimal functional entities—is in effect an end-run around application of normal transfer pricing rules under the ALP (including revised TPG Chapter VI).

II. Specific concerns

A. Part I of Actions 8–10 PDD, proposing changes to § I.D of the TPG

1. Relevance of the ALP to risk and possible recharacterization

a. The ALP can be interpreted to require transfer pricing of all associated enterprise commercial relations

Paragraph 1.6 of the TPG provides that the authoritative statement of the ALP is found in Article 9 of the OECD MTC:

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

The ALP grounds application of the TPG—including analysis of risk and the possibility of recharacterization—so it’s important to review what this sentence says about those two topics. If the difference referenced in the opening clause of the sentence exists, an allocation of profits among the associated enterprises is allowed by the second part of the sentence. In the phrase “those which would be made between independent enterprises,” “those” refers to conditions that would be made between independent enterprises. So the opening clause asks whether there’s a difference between certain conditions that exist (“are made or imposed”) between associated enterprises and hypothetical conditions (“those which would be made”) between independent
enterprises. But the ALP is more precise. The existing conditions among associated enterprises must relate specifically to “commercial or financial relations” between such enterprises. But to what must the hypothetical conditions among independent enterprises relate? Because the conditions are hypothetical, the ALP doesn’t require evidence of actual independent enterprise behavior. The hypothetical nature of the conditions must relate to supposed (i.e., assumed) behavior of independent enterprises—i.e., for purposes of seeking any difference in conditions in the first clause of the ALP—the independent enterprises must be supposed or assumed to be doing something to which the (hypothetical) conditions relate. A difference in conditions would generally be meaningless if the commercial relation between associated enterprises involved, say, an intangible transfer but that between independent enterprises involved the provision of services. Comparing conditions is only meaningful if the hypothetical independent enterprises are assumed to be engaging in the same commercial relation as that between the associated enterprises. That is, the comparison in the first clause of the ALP is only meaningful if the clause is interpreted as “[where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises engaging in the same commercial or financial relations.”

Various arguments might be raised against this interpretation, but they don’t withstand scrutiny under the ALP. One argument is that the emphasized phrase isn’t there and it shouldn’t be inferred. As pointed out above, however, inferring such a requirement allows an apples-to-apples comparison: assume hypothetical independent enterprises engage in the same commercial relation as that existing between associated enterprises, and only then compare the conditions made or imposed between the two sets of parties.
Another argument might be that one isn’t—under the ALP—free to assume the hypothetical independent enterprises engage in the same commercial relations as that among associated enterprises. Rather, it might be argued, under the ALP one is restricted to commercial relations independent enterprises would engage in, in the sense that if as a matter of economics independent enterprises wouldn’t normally engage in a commercial relation then one can’t assume for purposes of the ALP comparison that they do engage in it. But the ALP by its plain terms seeks to compare actual conditions (between associated enterprises) with hypothetical conditions (between independent enterprises), and the hypothetical conditions (“those which would be made”) must relate to a hypothetical commercial relation—that which would be made between independent enterprises. Interpreting the ALP to prevent the hypothetical commercial relation among independent enterprises from being one not normally engaged in among independent enterprises would violate a canon of statutory construction: it would make the ALP inoperative in situations in which associated enterprises undertake transactions not normally engaged in, or not observable, among independent enterprises. \(^3\) This interpretation should accordingly be rejected. The more natural reading of the ALP—that the comparison of conditions in the ALP should be done assuming independent enterprises engage in the same commercial relation as that of associated enterprises—allows the ALP to function in all circumstances: (1) assume independent enterprises engage in the same commercial relation as that existing between associated enterprises; (2) find the conditions that would be made or imposed between such independent enterprises; (3) compare those conditions with those actually made or imposed between the associated enterprises; and (4) determine the “delta” in profits that

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\(^3\) Critics of our interpretation might argue that this breakdown of application of ALP is precisely what permits recharacterization, but there’s nothing in Article 9 (or the Commentary for that matter) suggesting such inapplicability of the ALP with consequent allowance of recharacterization.
can be included in the income of the relevant associated enterprise and taxed accordingly. The purpose of the ALP must surely be not to force commercial relations among associated enterprises to mirror those among independent enterprises, but rather to suitably price associated enterprise relations.

A variant of the last argument is that by assuming in the ALP that hypothetical independent enterprises engage in the actual commercial relation undertaken by associated enterprises, it may not be possible as a matter of economics to determine (to solve for) the appropriate transfer price. This argument also can be refuted. It may be possible to find associated-enterprise transactions not normally observable among independent enterprises. But this doesn’t mean that hypothetical independent enterprises assumed to have entered into such a transaction wouldn’t arrive at a constellation of contract provisions, risk sharing, and pricing terms that optimizes their respective economic positions. This is discussed further below.

To summarize, finding the difference sought in the first clause of the ALP doesn’t require one find evidence of independent enterprises in the same commercial or financial relation as that existing between associated enterprises. The use of “which would be made” means the conditions must be hypothetical, and the difference is only meaningful if one assumes the hypothetical independent enterprises engage in the same “commercial or financial relation[]” as that actually consummated by the associated enterprises. The ALP should operate to price associated enterprise transactions, not restrict—upon penalty of recharacterization—the set of transactions among such enterprises to those that independent enterprises would, under various assumptions, normally only engage in.
b. Associated enterprise commercial relations and risk

An important element of the conditions associated with a commercial or financial relation between associated enterprises is the set of risks borne by each enterprise under this relationship. As the *Actions 8–10 PDD* notes, these risks can arise from a variety of factors external or internal to these enterprises, such as the economic environment in relevant markets, the degree of competition they face in relevant markets, the reliability of the supply chain for raw materials, or uncertainties in employee capabilities.  These risks may be described as “extrinsic” to the associated enterprises in that they are substantially outside the control of these enterprises while being material to the outcome of their commercial relations. To find a transfer price under the ALP, a commercial or financial relation between independent enterprises must be imbued with the same extrinsic risks as the relations between associated enterprises to serve as a benchmark for arm’s length terms in the latter.

When independent enterprises are placed in a relationship with the same extrinsic risks as an associated enterprise relationship, however, additional risks could arise that may not occur between associated enterprises. These risks arise when an independent enterprise is unable fully to observe or regulate the conduct of the other independent enterprise within the relationship, and terms of the relationship incentivize one such enterprise to take actions that may not be in the best interests of the other. For example, if a firm engages an independent contract manufacturer to make its products and stipulates payment terms independent of the quality of the products, the manufacturer might have an incentive to reduce its quality control efforts to save costs. These risks arising from imperfect observability and control can be termed “moral hazard” risks.

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4 *Action 8–10 PDD*, § D.2.1. ¶ 42.
Although it’s possible for moral hazard to arise among associated enterprises, the likelihood and the scale of moral hazard is typically greater between independent enterprises.

Independent enterprises can adopt a variety of measures to curb moral hazard risks in their commercial or financial relations. First, moral hazard risk can be mitigated through provisions of a contract governing the relation. For example, the terms of their contract can allow one enterprise to monitor the actions of the other to the extent feasible (for example, through rights of periodic inspection) or to penalize misbehavior by the other if such misbehavior can be observed after the event. To the extent moral hazard cannot be eliminated through enforceable contract terms, it can be mitigated through the provision of incentives within the contract. For example, under certain conditions, the contract may, to align incentives of both enterprises to deal with extrinsic risks, stipulate a compensation structure that exposes both enterprises to extrinsic risks. Such risk-sharing contracts, however, may be inefficient in other settings where one enterprise is highly risk-averse or has limited capacity to manage risks to which it’s being exposed. Finally, given the contractual provisions and the structure of extrinsic risk-sharing agreed upon by the parties, the specific payment terms chosen by independent enterprises will reflect any moral hazard that remain within their commercial or financial relations. Thus, if the nature of the moral hazard is that one enterprise may provide a sub-optimal level of effort in its stipulated tasks, the value of the payments the other enterprise will agree to make will likely be lower to reflect the anticipated value-loss arising from this moral hazard.

Given the different ways independent enterprises can deal with moral hazard, the conditions chosen by such enterprises for a particular commercial or financial relation may lie anywhere on a spectrum of possible outcomes, characterized by different combinations of
contractual restrictions, incentive structures, and payment levels. Depending on the nature of the activity involved in this relationship, the degree of observability in the actions of the enterprise, or their degrees of risk aversion, we may find some enterprises choosing to impose significant contractual restrictions on behavior and limited risk-sharing, with a corresponding level of stipulated payments. Others might choose limited contractual restrictions on behavior but significant risk-sharing, with a different level of stipulated payments. Yet others might agree to few contractual restrictions or risk-sharing but with significant adjustments to the resulting stipulated payments.

Under these circumstances, with arm’s length conditions for a particular commercial or financial relationship potentially falling anywhere within a set of possible combinations of conditions, how should the ALP be applied? In pursuing the ultimate objective of the ALP—the determination of the arm’s length transfer price—one must ensure the conditions of commercial or financial relations between associated enterprises match those that would be observed among independent enterprises engaging in the same relations. The ALP thus requires the following analysis. When evaluating a certain relationship between associated enterprises, hypothesize that independent enterprises enter into the same relationship, entailing the same activities, undertaken with comparable assets, and exposed to the same extrinsic risks. Further, hypothesize that these independent enterprises also choose the same contractual terms and the same allocation of extrinsic risks that the associated enterprises have chosen. Now ask: what specific payment terms would the independent enterprises agree upon under these circumstances? Applying these payment terms to the transaction between associated enterprises will ensure their relationship is consistent with the ALP.
As an illustration of how the ALP applies to determine a transfer price, consider an enterprise that licenses certain intangible property to an associated enterprise for commercial exploitation in certain markets. The two associated enterprises agree upon certain contractual restrictions on the licensee’s use of this intangible property and agree further to share extrinsic risks by stipulating that royalty payments will be contingent on the actual revenues generated by products incorporating the licensed intangibles. To determine the arm’s length royalty rate, we would examine any evidence of independent enterprises licensing comparable intangibles, with comparable commercial potential, facing comparable extrinsic risks, operating under comparable contractual restrictions, and structuring license payments as royalties contingent on sales. The royalty rates in such independent enterprise licensing agreements would serve as the arm’s length royalty rates for the associated enterprise transaction. If, by contrast, the intangible property owner licensed the intangible with a stipulated lump-sum payment from the licensee to the licensor, so that the risks of extrinsic outcomes are borne entirely by the licensee, we would have to look for evidence on how independent enterprises would set a lump-sum payment when entering into a comparable commercial relationship now marked by focusing extrinsic risks on the licensee. If no such evidence was observable, other transfer pricing methods can yield an arm’s length lump-sum price.

As discussed above, the payment terms observed among independent enterprises will reflect any moral hazards that arise in their commercial or financial relations, given the contractual provisions in these relations and the allocations of extrinsic risk undertaken. Therefore, the ALP requires that the payment terms between associated enterprises should reflect not only extrinsic risks but also the moral hazard that would arise between independent enterprises if they were to engage in the same relations on similar terms. The ALP thus requires
associated enterprises to select payment terms that embed a compensation for moral hazard risks they may not actually bear, or bear only to a much smaller degree. The ALP thus properly interpreted has the advantage of allowing associated enterprises to draw on the significant body of market evidence on payment terms between independent enterprises to establish intercompany payments, without requiring adjustments for the absence of moral hazard risks.

The ALP, as articulated above, is consistent with transfer pricing methods that have had a well-established history both in the TPG and in U.S. transfer pricing regulations. The Comparable Uncontrolled Transaction (“CUT”) method identifies arm’s length payment terms with respect to payments between independent enterprises engaged in comparable commercial relations under comparable contractual terms and allocations of risk. To the extent moral hazard exists in comparable relations between independent enterprises, this moral hazard is already embedded in the payment terms of CUTs. Similarly, the profit margins of enterprises performing economic activities through market-mediated transactions with unrelated firms reflects the effect of moral hazard in these transactions, at least to the extent they’re sufficiently material to affect the pricing of these transactions. Transactional net margin methods—which determine intercompany prices in relation to the profit margins of independent enterprises performing comparable activities—thus also reflect moral hazard risks prevalent in the market-mediated transactions of such enterprises.

In certain situations, the commercial or financial relations between associated enterprises are not directly comparable to relations observed between independent enterprises. As the OECD Guidelines repeatedly recognize, however, the absence of a directly comparable transaction between independent enterprises doesn’t mean a transaction between associated
enterprises isn’t arm’s length.\textsuperscript{5} One can use methods described in the TPG and U.S. Treasury Regulations for determining payment terms independent enterprises would negotiate under the conditions applying to the transaction between associated enterprises. The requisite economic analysis might consist of determining an appropriate adjustment to the terms of market transactions that are substantially similar to the associated enterprise transaction except for particular contractual terms or extrinsic risk allocations. Alternatively, where appropriate, this analysis might entail a fundamental analysis of how independent enterprises might split the aggregate profits from the subject transactions within a profit split method. Considerations of moral hazard risks may require economists to analyze the effects of information and incentives in finer detail within their models but this doesn’t impugn applicability of such non-transactional methods in determining arm’s length payment terms.

2. \textbf{Proposed changes to § D.2 of the TPG—moral hazard and risk-return trade-off}

The \textit{Actions 8–10 PDD} invites comments on several issues relating to moral hazard, the risk-return trade-off and their implications for the ALP.

\textbf{Question 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 ALP requires payment terms between associated enterprises to be determined with reference to payment terms that would be observed among independent enterprises engaged in the same commercial or financial relation under comparable contractual provisions and comparable allocations of extrinsic risk. As discussed in § II.A.1.b above, payment terms

\textsuperscript{5} TPG, ¶ 1.11.
negotiated between independent enterprises under such conditions will reflect any moral hazard risk remaining between these enterprises under these conditions. Arm’s length payments between associated enterprises will thus generally reflect moral hazard risks arising among independent enterprises operating under the same commercial relationships under similar contractual provisions and comparable allocations of extrinsic risk.

The fact that arm’s length payment terms reflect the moral hazard operating between independent enterprises doesn’t mean that moral hazard risks and the corresponding contractual incentives between such enterprises are being imputed to associated enterprises. As discussed above, the existence of common control between associated enterprises may reduce moral hazard between such enterprises. To impute all independent enterprise moral hazard risks to such associated enterprises would be to imbue the associated enterprises with risks they may not actually face. Arm’s length payments reflect moral hazards faced by independent enterprises because: (a) market prices, the best source of information on the pricing of economic transactions between independent enterprises, reflect moral hazards faced by such enterprises in their dealings with each other; (b) there’s little market-based evidence to adjust these prices for the absence of moral hazard, precisely because moral hazard typically arises in market-mediated transactions; and (c) the use of such market prices has the virtue of being consistent with long-established and widely adopted methods of transfer pricing analyses, which are based on direct evidence or economic modeling of the terms on which independent enterprises would transact.
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?

The observation is correct only in the limited sense that such lack-of-sharing behavior “may” be observed, but it’s incorrect as a general matter. In many technology-intensive industries, such as semiconductors, networking or computer hardware, technologies that have to be integrated within a final product used by consumers are developed by independent enterprises. These enterprises have developed effective contractual mechanisms to share vital information about their proprietary technologies with other firms in the value chain to facilitate a mutually advantageous cohesion in their technology development efforts.6

The prevalence of such agreements within the information economy indicates that it’s possible to design a set of contractual provisions that enable proprietary information to be transmitted through market-mediated relationships to facilitate certain transactions while preventing its leakage into unintended uses. If a transaction among associated enterprises would involve the transmission of valuable intellectual property or core competencies from one enterprise to another, the arm’s length conditions for this transaction can thus be determined as follows: (i) first, hypothesize a transaction between independent enterprises involving the same functions and requiring the same flow of proprietary information from one such enterprise to the other; (ii) identify contractual provisions that would effectively constrain each such enterprise from using the other’s proprietary information in unintended ways; (iii) conduct an economic

6 Many examples can be offered for such mutually advantageous flows of information. One such example arises in the world of enterprise software, where the developers of operating systems for enterprise computing systems share proprietary information about their software code with independent developers of tools that enhance the productivity of these operating systems for consumers. A variety of contractual, relational, and compensation mechanisms have emerged to curb moral hazard and information risks among independent enterprises, thereby helping companies develop and exploit knowledge-based assets within such relationships.
analysis to identify the additional costs and risks (if any) borne by each such independent enterprise as a result of the constraints to which it’s subjected under these contractual provisions, offset by the anticipated economic benefits they stand to realize by complying with these provisions; and (iv) in light of these economic benefits, costs, and risks, determine the payments to be made by the independent enterprises to each other under the transaction. Such an analysis may be economically complex, but it’s not qualitatively different from the analyses required to quantify other complex sources of economic benefits, costs, and risks.

**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?**

In this example, the *Actions 8–10 PDD* asserts that a potential moral hazard could arise because Company S2, which will own the trademark after the sale transaction, doesn’t perform the extensive marketing functions needed to maintain and enhance the trademark. These functions will continue to be performed by the seller of the trademark, Company S1, under the monitoring and supervision of S2. However, S1 will now be performing these marketing functions for the benefit of a trademark it doesn’t own or fully control. Under these conditions, ¶¶ 90–91 asserts that the proposed sale of the trademark would create moral hazards so acute as to render the sale economically infeasible if S1 and S2 were independent enterprises.8

This conclusion is unjustified by the facts in ¶¶ 90–91. We’re told that as part of the agreement under which S1’s trademark is sold to S2, S1 gets a license from S2 to use the trademark in exchange for an annual royalty payment. The example is silent on whether this

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7 We raise other concerns with this example below, in § II.A.3, below, where we discuss how the *Actions 8–10 PDD* addresses recharacterization under the ALP.

8 This assertion relates to the “fundamental economic attributes” test the *Actions 8–10 PDD* fashions to permit recharacterization of associated enterprise transactions. We address this test in § II.A.3, below.
license is exclusive in S1’s territory. If the license is exclusive, it’s readily seen that S1 will have a strong incentive to maintain and enhance the trademark as effectively as possible, because S1 will get any incremental revenues that arise from the enhanced value of the trademark. Provided the royalty rate for the license is set efficiently to leave some benefit of these incremental revenues with S1, S1’s incentives to maximize the value of the trademark will be strong. Knowing this, S2 will be prepared to purchase the trademark from S1 for a lump-sum that reflects the present value of the anticipated future royalty stream from licensing the trademark back to S1. This lump-sum amount also should fully compensate S1 for the anticipated income foregone by selling the trademark.

Paragraph 91 expresses the concern that “Company S2 has no practical safeguards and is dependent on S1 to act appropriately . . . and S2 itself does not direct the way in which it can optimize returns on its asset.” But this concern is moot in light of the strong alignment of incentives between S1 and S2 regarding the value of the trademark. Equally moot is the concern that “Company S1 is theoretically subject to the constraints of the terms agreed with S2 on ongoing activity related to the maintenance and enhancement of the trademark.” Given their shared interest in maximizing the value of the trademark, S1 isn’t constrained by contract terms that require it to conduct marketing activities for the trademark because S1 has a direct economic incentive to do so even in the absence of such terms.

There remains the question of how S1 “enhances or protects its commercial or financial position” through such a transaction. Even if the lump-sum compensates S1 for the income foregone by selling the trademark, why should S1 not just hold on to the trademark and realize this stream of anticipated trademark income in the future rather than converting this income into a lump-sum amount up-front through the sale of the trademark? Again, ¶¶ 90–91 are silent on
the facts necessary to evaluate this question, but one can envisage circumstances under which the sale of the trademark would be beneficial to S1 and S2. If S1 is specialized in the business associated with the trademark, its risks are concentrated in this business. Considered as an independent enterprise, S1 may have an interest in diversifying its business risks. Selling the trademark for a lump-sum and then investing this lump-sum in an uncorrelated activity or financial instrument allows S1 to achieve this diversification. Depending on its circumstances, S2 may be in a better position to bear the risks associated with the trademark than S1. This could happen if S2 holds other intangible property rights that aren’t highly correlated with the trademark (e.g., if S2 owns a broad portfolio of intangible property rights). If S2 can bear the risks of the trademark better than S1 can, the trademark would be more valuable in S2’s hands than S1’s. If so, this would be an added rationale for the transaction.

As an alternative to incentives, S2 may consider contractual provisions as the solution to S1’s potential moral hazard. Paragraph 90 notes that S2 has several employees with capability to “assess, monitor and direct the use of the trademark by S1.” These capabilities may ensure that S2 can assess the marketing activities needed to enhance the value of the trademark, direct the efforts of S1 in performing these activities and monitor whether S1 is performing the specified tasks. These capabilities are sufficient to support contract provisions stipulating actions S1 should take, identify any failures by S1 to perform these tasks, and impose penalties in this eventuality. Thus, as an alternative to incentives, contract provisions can also serve to effectively bind S1 into acting in the interests of the trademark.

We’ve so far assumed that after the sale of the trademark, S2 will license the trademark back to S1 on an exclusive basis. This assumption isn’t necessary for the overall transaction between S1 and S2 to be viable. If S2 licenses the trademark back to S1 only on a non-exclusive
basis, S1 will have to consider the possibility that its marketing efforts aimed at maintaining and enhancing the trademark will benefit not only its own future sales but also sales of potential rival manufacturers who may license the same trademark. S2 can still maintain S1’s incentive to provide such marketing efforts for the trademark by making S1’s compensation for these efforts contingent in some form on aggregate sales of all products sold under the trademark (not just S1’s sales). Now, after S1 initially sells the trademark to S2 for a lump-sum amount, S1 will still have an incentive to enhance the overall value of the trademark through its marketing efforts because it retains a financial interest in this overall value through its compensation for these marketing efforts.

As a non-exclusive licensee and producer of goods sold under the trademark, S1 may lose some market share after the transaction if S2 licenses the trademark to other enterprises. However, S1 can recover the value of these lost profits up-front through the lump-sum price it charges S2 for the trademark. If this price is properly calibrated, S2 should be in a position to pay this price because it gets the incremental profits earned by the trademark from licenses to enterprises other than S1. Of course, careful economic analysis will be necessary to establish the economically efficient set of lump-sum values and royalty rates.

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

Independent enterprises transacting at arm’s length often enter into transactions whose sole economic effect is to shift risk. A classic example is the purchase of insurance. When a firm enters into a contract with an insurance provider to insure against the risk of an adverse business outcome (for example, the firm buys business casualty insurance), the firm is shifting
the risk of this outcome to the insurance provider. In exchange, the firm pays the insurance provider a series of stipulated payments (or insurance premiums) to bear this risk.

Between associated enterprises, an example of pure risk-shifting arises when a parent company implicitly or explicitly guarantees the debt of its subsidiary. Without such a guarantee, the subsidiary would have to pay its creditors an interest rate that included not only a benchmark borrowing rate such as the prime rate but also a spread above this rate for the default risk associated with its borrowing. If the parent company is regarded as more credit-worthy than the subsidiary, the parent’s guarantee will ensure the subsidiary will have to pay its creditors only the lower interest rate associated with the parent company. At arm’s length, the subsidiary will have to compensate the parent for providing this guarantee. Drawing on well-established models for pricing credit risk, it’s possible to determine the lump-sum payments or the stream of annual premiums that would give the parent company an actuarially fair return on its anticipated payment obligations under the guarantee.

So pure risk-shifting transactions occur regularly between independent enterprises, and they can also arise between associated enterprises. They should therefore be recognized as valid transactions\(^9\) and priced according to well-established analytical models for the pricing of risk.

**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?

As discussed above in response to Question 3, the sale of the trademark by S1 to S2 will likely reduce S1’s exposure to the aggregate risks of the business in which this trademark is

\(^9\) This assumes that the economic substance of such transactions is consistent with their form (see discussion below in § II.A.3.a.i).
used. In exchange for the risky stream of incremental income associated with this trademark, S1 gets a fixed lump-sum amount, which can be invested in other income-generating assets whose risks are different from those of the trademark’s line of business.

By contrast, the same transaction increases S2’s exposure to the risks of the trademark’s line of business. However, the lump-sum paid by S2 to S1 would fairly compensate S2 for holding this risk. Specifically, under economic principles for the pricing of risky cash flows, the trademark should be valued by first identifying the risk-adjusted return S2 should expect to get for being exposed to the trademark’s overall risks. The lump-sum value of the trademark should be the present value of the incremental expected future income from the trademark, discounted at this risk-adjusted rate of return. At this value, S2 will earn the risk-adjusted expected return on the amount spent to buy the trademark.

If S2 is better positioned to bear the risks of the trademark than S1 (for example, because S2 has alternative assets or investments, that provide better diversification for the trademark’s income stream, than has S1, which is specialized in the business associated with the trademark), the risk-adjusted expected return S2 requires to hold the trademark is lower than the corresponding expected return S1 requires. Therefore, S2 would value the trademark more highly than S1.\(^\text{10}\) If so, both enterprises can stand to gain from the transfer of the trademark from S1 to S2.

\(^{10}\) The discount rate used by S2 to determine the present value of the trademark’s expected income would be lower than that used by S1. Therefore, the present value of the trademark’s expected income will be higher for S2 than for S1.
Question 6. In the example at paragraphs 90 and 91, how should the risk-return tradeoff implications be taken into account under the arm’s length principle?

The answers to the previous questions also indicate the answer to this question. As the Actions 8–10 PDD notes, the risk-return tradeoff principle supports the notion that it’s economically rational to take on (or lay off) risk in return for higher (or lower) anticipated nominal income.\(^1\) The example in ¶¶ 90–91 illustrates the application of this principle both for S1 and S2. First, S2 takes on risks associated with the income from using the trademark. S2 gets royalty payments by licensing the trademark to S1, but S2 also has to pay S1 a lump-sum amount to buy the trademark from S1. These two streams of payments are connected; the lump-sum value paid by S2 to S1 should equal the present value of S2’s anticipated income from licensing the trademark, computed at a discount rate that reflects the risks associated with the trademark’s royalty stream. The higher this risk-adjusted discount rate, the lower is the value S2 should pay as a lump-sum in exchange for the royalties anticipated from S1. The net effect of the sale and subsequent license is that by paying up-front the discounted value of the anticipated future income stream from the trademark license, S2 is in the position to realize an expected return equal to the risk-adjusted discount rate from purchasing the trademark. Thus, in summary, S2 takes on the higher risk of the trademark’s income in exchange for an expected return that includes a risk-premium commensurate with the risks incorporated in the trademark’s expected income stream.\(^2\)

\(^1\) Actions 8–10 PDD, p. 14.

\(^2\) If S2 gives S1 not an exclusive but rather a non-exclusive license to the trademark, and licenses the trademark to other firms, as discussed above S2’s risk profile changes but the overall conclusion remains the same.
As the counter-party to both legs of this transaction, S1 is in the reverse of S2’s position. Specifically, S1—by getting the lump-sum but giving up the future income stream—is giving up the risk-adjusted expected return on the trademark’s future income in exchange for not bearing the risks of the trademark. Therefore, the choices of both S1 and S2 are consistent with Actions 8–10 PDD’s risk-return trade-off principle.

**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? 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?

Yes, the risk-return trade-off does, under the ALP, apply in general to transactions involving as part of their aspect the shifting of risk (see the answer to question 6). Question 7a) is unclear, but seems directed at putative “opportunistic” behavior of taxpayers. The discussion in this letter regarding risk-return trade-off presumes proper application of the ALP, accurate assessment of risks, and justifiable use of corresponding discount rates. Question 7b) is excessively open-ended. We believe BEPS concerns are adequately addressed within the ALP (including perhaps a special measure allowing, in narrow circumstances and subject to the ALP, ex post adjustments to be made to associated enterprise transfer prices) and perhaps by the implementation of adequately-tailored CFC regimes. The response to question 5 shows, consistent with the risk-return trade-off principle, that associated enterprise transactions can—depending in part on the risk profiles—enhance the economic positions of both enterprises and may be observable among independent enterprises. The function of the ALP, however, is to
price associated enterprise transactions based on hypothetical behavior of independent enterprises.

3. Proposed changes to § D.4 of the TPG—non-recognition
   a. General comments
      i. The ALP doesn’t justify recharacterization of an associated enterprise transaction unless the economic substance of such transaction doesn’t mirror its form

   Section D.4 of the TPG involves fundamental attributes of associated enterprise transactions, and it’s critical to keep in mind some basic tax principles.

   The first concerns “economic substance.” The tax laws of many countries have—either in common law or in statute—a version of the economic substance doctrine allowing a tax authority to disregard the form of a transaction as structured by a taxpayer and recharacterize it (i.e., treat it for tax purposes) according to its perceived “economic substance.” This is most often, but not exclusively, applied to transactions involving associated enterprises. A tax authority may, for example, assert that a transaction structured by associated enterprises as a sale is in economic substance a structured financing arrangement, and tax it accordingly.

   The ability to disregard the form of an associated-party transaction and recharacterize it according to its economic substance must be a fundamental part of the ALP. Obviously one must, when applying the ALP, know the substance of the “commercial relations” between associated enterprises because under the ALP this commercial relation is imputed to the independent enterprises so an arm’s length transfer price can be found. If a transaction among associated enterprises lacking economic substance is imputed to independent enterprises, the wrong transfer price will result. This application of economic substance principles looks to what
in substance the associated enterprises are doing, and ignores considerations of whether independent enterprises would do this. If the form of an associated enterprise transaction has economic substance—if, for example, a transaction whose form is a license is in economic substance also a license—the transaction should be respected for transfer pricing purposes.\textsuperscript{13}

A similar use of economic substance characterization of a transaction comes when one performs a comparability analysis. Obviously one must, for comparability of contracts with independent enterprise transactions, use what is in economic substance the associated enterprise transaction.\textsuperscript{14}

Consistent with this discussion of recharacterization that must be allowed under the ALP, ¶ 1.65 of the TPG allows a tax administration—if the economic substance of a transaction differs from its form—to “disregard the parties’ characterisation of the transaction and re-characterise it in accordance with its substance.”

The TPG assert in ¶ 1.65 that for transfer pricing purposes, being able to recharacterize a transaction consistent with its economic substance isn’t enough—tax administrations need a further recharacterization tool. To justify this additional recharacterization authority, the TPG discusses an example of—

\begin{quote}
a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research
\end{quote}

\textsuperscript{13} See, e.g., U.S. Treasury Regulation § 1.482-1(f)(2)(ii)(A) “The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance.”

\textsuperscript{14} See, e.g., U.S. Treasury Regulation § 1.482-1(d)(3)(ii)(B)(i) “The contractual terms, including the consequential allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions.”
for the term of the contract (as indicated in paragraph 1.11). While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.\(^\text{15}\)

The example posits enterprise X selling to associated enterprise Y for a lump sum payment “unlimited entitlement to the intellectual property rights arising as a result of future research.” The example doesn’t say so, but presumably the research is done on some underlying set of intangible property;\(^\text{16}\) the example also doesn’t say which enterprise owns the underlying intangibles, but from the conclusion we can suppose it’s Y. That is, what’s happening in the example is X nominally selling Y, for a lump sum “unlimited entitlement to the intellectual property rights arising as a result of future research” done on intangible property owned by Y. But if X doesn’t own the underlying intangible property it has nothing to sell Y—X is merely providing services to Y: this is the economic substance of the arrangement. Tax case law is used to addressing these situations by gleaning the substance of a transaction.\(^\text{17}\) No new recharacterization tool is needed, merely proper application of the existing economic-substance-over-form recharacterization tool.\(^\text{18}\) Thus the proffered example justifying the need for another recharacterization tool doesn’t support the need for it.

\(^{15}\) TPG, ¶ 1.65.

\(^{16}\) Reference to “continuing research” supports this presumption, but the presumption isn’t necessary—the same conclusion obtains if X purports to “sell” Y any fruits of future “blue sky” research not based on existing intangibles.


\(^{18}\) If in fact the example intended X to own the underlying intangibles then X could sell “unlimited entitlement to the intellectual property rights arising as a result of future research” done on the underlying intangibles X owned, and if so X wouldn’t be performing R&D services for Y.
As explained above, the ALP by its terms doesn’t require or condone recharacterization of a transaction assuming the economic substance of the transaction mirrors the form. With this assumption, the ALP posits that independent enterprises engage in the same commercial relation (transaction and extrinsic risks) as that between associated enterprises, and then determines the appropriate transfer price based both on the imputed extrinsic risks and any moral hazard risks arising. There’s a distinction between recharacterizing or disregarding a transaction between associated enterprises and recharacterizing or disregarding a particular term or terms of such a transaction—in particular, pricing terms. In the case of transactions involving hard-to-value intangibles one might argue that in some circumstances a form of ex post pricing is warranted. To emphasize, this would respect the overall transaction but simply recast the amount and form of the pricing to be based on actual outcomes. This is precisely the approach of special measure Option 1 in the Actions 8–10 PDD, dealing with hard-to-value intangibles (discussed below).

Taxpayers should not be subject to this modification to the pricing terms of their associated enterprise arrangements if they can demonstrate conformity with the ALP—i.e., the authority to make ex post adjustments to the amount and form of pricing terms in the case of hard-to-value intangibles should always be subject to the ALP.

ii. **The “fundamental economic attributes” test for recharacterization in the Actions 8–10 PDD rests on flawed reasoning**

As just explained, the ALP strictly doesn’t condone disregard or recharacterization of a structure adopted by associated enterprises in entering into a controlled transaction unless the economic substance of the transaction differs from its form. The example in ¶ 1.65 of the TPG allegedly justifying an alternative tool for recharacterizing associated enterprise transactions can be readily dealt with using economic-substance principles, and doesn’t justify a second ground
for recharacterizing associated enterprise transactions. The second recharacterization tool is set out as follows:

The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.19

This ground for recharacterization is difficult to understand, but in any event it’s not justified under the ALP, nor is it needed to apply the ALP to get an arm’s length price. The Actions 8–10 PDD, however, to give “greater definition”20 to this alternate test for recharacterization, recasts the alternate test and ends up with a “fundamental economic attributes” test for disregarding associated enterprise transactions.

The plain meaning of this alternate test is that two requirements must each be met for recharacterization to be permitted: (i) commercial arrangements made in relation to an associated enterprise transaction “differ from those which would have been adopted by independent enterprises behaving in a commercially rationale manner;” and (ii) “the actual structure practically impedes the tax administration from determining an appropriate transfer price.” The Actions 8–10 PDD calls this the “two legs” test. The plain meaning of this test is that if either requirement (i) or (ii) isn’t met, recharacterization isn’t permitted. But the Actions 8–10 PDD states that the “two legs can lead to the assertion that if you can find a price, the arrangement is not commercially irrational.” This assertion would be unfounded—the legs are independent, so

19 TPG, ¶ 1.65.
20 Actions 8–10 PDD, ¶ 88.
failing requirement (ii) generally says nothing about whether requirement (i) is met or fails. The assertion doesn’t comport with a plain reading of the two legs test.

But the Actions 8–10 PDD makes this assertion apparently to cast doubt on the two legs interpretation, which it contrasts with “interpreting the pricing impediment reference as an inherent quality of an arrangement lacking commercial rationality.” With this, the Actions 8–10 PDD recasts the two legs test—which nominally says a tax administration can recharacterize if both requirements (i) and (ii) are met—into something different: it asserts that if requirement (i) is met (i.e., commercial irrationality) then requirement (ii) will be met (i.e., impedance of appropriate transfer price). Thus according to the Actions 8–10 PDD, requirement (ii) is redundant: “commercially irrational” arrangements—whatever that might mean—would automatically impede appropriate transfer pricing. The focus then, according to the Actions 8–10 PDD—shifts from determining an appropriate transfer price (which is the base function of the ALP) to commercial rationality (which is arguably indeterminate).

The Actions 8–10 PDD asks “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.” With this, the Actions 8–10 PDD has replaced requirements (i) & (ii) of the two leg test for recharacterization (which isn’t in the first place justified under the ALP) with just requirement (i) (because, the Actions 8–10 PDD asserts, requirement (ii) is automatically met if requirement (i) is), and then replaced requirement (i) by a “fundamental economic attributes” requirement.

As a final step, the Actions 8–10 PDD explains the “fundamental economic attributes” requirement—
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. 21

The Actions 8–10 PDD in essence asserts that if a transaction didn’t offer two independent enterprises “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,” the transaction likely wouldn’t be observed among independent enterprises. What the “fundamental economic attributes” test thus does is allow a tax authority to recharacterize any associated enterprise transaction that likely wouldn’t be observed at arm’s length.

What the Actions 8–10 PDD has done in ¶¶ 88–89 is take a test for recharacterization of associated enterprise transactions that isn’t justified under the ALP, and in any case is hard to understand, 22 and—purporting to give “greater definition” to the test—replaced it with the “fundamental economic attributes” test, which in essence would allow recharacterization of any associated enterprise transaction that isn’t observed among independent enterprises. This isn’t justified. The original two step test for recharacterization arguably had no basis in the ALP. Particular associated enterprise transactions may not always be observable among independent enterprises because of moral hazard risks that might arise among independent enterprises, but

21 Actions 8–10 PDD, ¶ 89 (emphasis added).

22 “That [commercial rationality] test can be difficult to apply since it is hard to delineate what independent enterprises behaving in a commercially rational manner would have done.” Actions 8–10 PDD.
this doesn’t mean that (a) such associated enterprise transaction doesn’t make sense economically intra-group; (b) a transfer price can’t be found (see the discussion above); or (c) the associated enterprise transaction must be recharacterized. The ALP by its terms, and normatively, applies to find a transfer price using the hypothetical behavior of independent enterprises assumed to be engaged in the same commercial relation as associated enterprises, taking into account the same extrinsic risks and any moral hazard risks that arise. Recharacterization of the related party transaction—other than to ensure economic substance mirrors form—is neither permitted nor needed under the ALP.

b. Comments on the example in ¶¶ 90–91 of Actions 8–10 PDD

The example in ¶¶ 90–91 of the Actions 8–10 PDD tries to show application of the “fundamental economics attributes” test, which as explained above is based on flawed reasoning and is in any case not required for proper application of the ALP. The Actions 8–10 PDD ignores the relevant question: what’s the transfer price in this case under the ALP? We make four interrelated points. First, the analysis in the example is in several places flawed. These failures were described in § II.A.2 above, where we addressed the example under questions 3, 5, and 6 posed in the Actions 8–10 PDD relating to moral hazard and risk-return trade-off. Second, the example posits that “extensive marketing functions with regard to the maintenance and enhancement of the trademark will be undertaken and managed by Company S1,” but also that “Company S2 has several employees with capability to assess, monitor, and direct the use of the trademark.” It’s unclear why Company S2’s direction of the use of the trademark wouldn’t overlap or even trump Company S1’s management of the maintenance and enhancement of the trademark. Third, trademark law best practices would have Company S2 conducting core

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23 Actions 8–10 PDD, ¶ 90.
trademark control functions — e.g., making decisions on what products to brand, their quality, etc. If Company S2 failed to conduct those functions, it may be subject to challenge that its trademark is invalid, and its trademark rights could be cancelled. Fourth, assuming Company S2 performs such core trademark control functions, the substance of the arrangements mirrors its form, and properly analysing the underlying economics, yields different results, as shown in the table below.

<table>
<thead>
<tr>
<th>Actions 8–10 PDD assertion</th>
<th>comments (assume S2 performs core TM mgmt &amp; control)</th>
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<tbody>
<tr>
<td><strong>S1</strong></td>
<td></td>
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| likely to have lost commercial value because it no longer owns the trademark key in generating its income | ◇ S1 received $400m—if price is arm’s length, commercial value of S1 shouldn’t drop 
 ◇ it’s wrong to assert that a sale for arm’s length price subject to license-back results in loss of commercial value for S1 |
| subject to additional risk it’s reliant on S2 (treated as independent under ALP) being willing to license TM and not to take actions that might enhance TM value for S2 but detract from S1 | ◇ sale of TM can be made subject to license back (a common commercial arrangement)—i.e., little risk (a common extrinsic risk) 
 ◇ situation of S2 taking actions that enhance TM value for S2 but detract value for S1 is extreme in a way not normal—generally one could expect enhancement in value of TM to benefit S1, too |
| “theoretically” subject to constraints of contract with S2 on ongoing activity relating to maintenance and enhancement of TM | ◇ if substance mirrors form, S1 is subject to constraints of services contract with S2 
 ◇ if S2 employees make core branding & other decisions relating to TM (i.e., properly manage TM) ⇒ benefit to S1 from performing functions directed by S2 employees |
| **S2**                     |                                                     |
| has no practical safeguards and is dependent on S1 to act appropriately to enhance & protect its asset (TM) through marketing functions S1 undertakes | ◇ S2 control substance mirrors contractual form 
 ◇ S2 makes core decisions re maintenance, enhancement, & protection of TM 
 ◇ S2 would contractually bind S1 to take no action adverse to TM (trademark law practice) |
| doesn’t direct way in which it can optimize returns on its asset (TM) | ◇ S2 makes core decisions relevant to optimizing returns on its asset |
| doesn’t direct way in which it can optimize returns on its asset (TM) | ◇ S2 makes core decisions relevant to optimizing returns on its asset |
| has less capability than S1 to manage & control marketing that will affect generation of income streams; | ◇ S2 has full capability to manage & control marketing |
| hasn’t enhanced or protected its commercial position but may have damaged it by not managing risks to achieve a return on its investment in the asset | ◇ S2 has enhanced or protected its commercial position by managing risks |
The point of the exercise is to show that varying the facts to parallel those in arrangements considered sound from a trademark law perspective, and assuming the substance of the arrangement mirrors its form, can yield a different result under the “fundamental economic attributes” test —but as explained above this test in any event should be rejected under the ALP.

B. Part II of Actions 8–10 PDD, proposing five special measures

The special measures in Option 1 and the primary rule in Option 5 warrant further consideration and could, if modified, form practicable BEPS tools for WP-6 to endorse. The special measures in Options 2–4 and the secondary rule in Option 5 should be rejected, however. Below we expand on these recommendations.

1. The special measures in Option 1 & the primary rule in Option 5 could, if modified, form practicable BEPS tools

a. Option 1—HTVI

i. General comments

The special measure in Option 1 shares features with “commensurate with income” adjustments permitted under § 482 of the U.S. Internal Revenue Code of 1986, as modified, and implemented under the “periodic adjustments” rule in § 1.482-4(f)(2) of the associated U.S. Treasury Regulations. Option 1 could, if suitably modified, be appropriate for dealing with hard-to-value intangibles.

By its terms, the special measure could be invoked if two requirements are met:

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24 As pointed out in § II.A.2 above, in the responses to questions 3, 5, and 6, the economic analysis in ¶ 91 supporting the conclusion in the Actions 8–10 PDD is flawed.
[1] a taxpayer fixes a transfer price for an intangibles transaction either as a lump sum or as a fixed royalty rate on the basis of projections without any further contingent payment mechanism; and

[2] the taxpayer doesn’t contemporaneously document those projections and make them available to the tax administration.

Thus the special measure wouldn’t operate in a situation in which a taxpayer adopts a lump sum or fixed royalty, but contemporaneously documents projections and makes them available to the tax administration. If the special measure is invoked, a tax administration could presume a price adjustment mechanism would have been adopted and would be permitted to “rebase the calculations based on the actual outcome, imputing a contingent payment mechanism.”25 Option 1 presents conditions under which the presumption would be rebuttable.

We recommend Option 1 be modified to make clear that any adjustments made under an HTVI special measure should be subject to the ALP and the TPG. Accordingly, the special measure wouldn’t operate in circumstances in which a taxpayer produced evidence of the same intangibles being the subject of transactions with independent enterprises under substantially the same circumstances as those of the associated-enterprise transaction. Any HTVI special measure should acknowledge the difficulty of making projections over multi-year periods and accordingly be inoperable if a taxpayer has, say, five post-transaction years in which no adjustments were warranted under the special measure.

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25 Actions 8–10 PDD, p. 41. We assume the contingent payment mechanism would be such that any adjustments would be based on actual income.
ii. Answers to framework questions for Option 1

[1] **Efficacy**—The modifications to Option 1 outlined above would improve it. The goal of getting closer alignment between transfer pricing outcomes and value creation may—in the absence of comparable transactions and absent a robust contemporaneous transfer pricing analysis—be furthered by a special measure, subject to the ALP, allowing a tax administration to make the rebuttable presumption outlined in the special measure, as modified.

[2] **Advantages/disadvantages**—Option 1 as modified would ensure the special measure operates within the framework of the ALP, which has long served as the yardstick for pricing associated-enterprise transactions. This would minimize risk of double taxation inasmuch as adjustments made under the special measure (as modified) would be covered by Article 9, ¶¶ 1 & 2 of the OECD MTC.

[3] **Likely effect**—Option 1 as modified likely wouldn’t encourage behavioral changes, other than to encourage robust and contemporaneous transfer pricing documentation.

[4] **Adaptation of TP rules**—Option 1 as modified would be subject to the ALP and TPG.

[5] **Targeting**—Option 1 as modified targets situations involving hard-to-value intangibles using bright lines rules that increase the likelihood of tax administrations agreeing a case meets the criteria for application of the measure and on the resulting measurement.

[6] **Tax advantage**—the special measure makes no reference to tax attributes; the measure as modified shouldn’t include criteria limiting it to circumstances where the arrangement results in a tax advantage to the group.
[7] **Ordering**—Option 1 as modified would be subject to the ALP and TPG, and thus become part of the “normal” transfer pricing rules.

[8] **Eliminating double taxation**—the special measure as modified would be subject to the ALP, so that adjustments made under the measure would be consistent with Article 9, ¶ 1, thereby under Article 9, ¶ 2 minimizing the risk of double taxation.

[9] **Excluding sectors**—no sectors should be excluded from application of the measure.
b. **Option 5—excess returns**

   i. **General comments**

   The primary rule special measure in Option 5, if applied to tax CFC income at the CFC’s ultimate parent jurisdiction and if suitably crafted, could address any residual BEPS concerns, after application of the ALP and TPG, about non-taxation of CFC income. A CFC approach at the ultimate parent jurisdiction level has long existed as a mechanism to deem income to the ultimate parent, and tax that income, based on income earned by the CFC.\(^{26}\) Significantly, the primary rule would have to operate after application of normal transfer pricing rules and after the impact of any local country taxes, withholding taxes, and any other gross income inclusion under a CFC regime\(^{27}\) with respect to that CFC to determine the effective tax rate on the CFC’s income. The transfer pricing ordering rule, the comprehensive approach mentioned above to determine the CFC’s effective tax rate, and any foreign tax credit mechanism in the parent jurisdiction, would minimize risks of double taxation. Accordingly, we endorse a suitably adjusted primary rule in Option 5 as a viable special measure. This special measure should—as referenced in the *Actions 8–10 PDD*\(^ {28}\)—be coordinated with that on Action 3 (strengthen CFC rules).

   The secondary rule special measure in Option 5 should be rejected, for several reasons. The primary rule would only be justified if modified as described above, and then only if applied in the jurisdiction of the ultimate parent of a CFC, but not in the jurisdiction of any other direct or indirect owner of the CFC. The parent jurisdiction, as location of the ultimate owner of a

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\(^{27}\) E.g., other provisions of U.S. Subpart F.

\(^{28}\) *BEPS Actions 8–10 PDD*, p. 38.
multinational group, has primacy of right in taxing “excess returns” of a CFC. Such parent jurisdiction may choose at any time to exercise its sovereign right to tax deemed income inclusions to a resident parent company of a CFC with excess returns, but it might also choose to defer taxation for a period of time (e.g., by only selectively deeming certain income of the CFC to be income of the ultimate parent). The parent jurisdiction’s deferral of taxation for a period of time shouldn’t create a free-for-all allocating rights to tax such excess returns to “other jurisdictions.” The secondary rule in Option 5 doesn’t specify what these “other jurisdictions” are, perhaps because it’s unclear what legal authority would justify an arbitrary “other jurisdiction” asserting authority to tax income earned by an arbitrary CFC. Certainly the arm’s length standard would not justify such allocation. Compounding this uncertainty is the unspecified “pre-determined rule” for allocating taxing jurisdiction over an arbitrary CFC’s excess returns. The ALP provides a principled way for jurisdictions of enterprises associated with the CFC for asserting taxing authority over returns properly earned at arm’s length by such associated enterprises, but what the secondary rule proposes is clearly different. Given the lack of specificity of the “pre-determined rule”—in effect, formulary apportionment—it’s unclear whether consensus could ever be reached among jurisdictions on what rule to choose. It’s equally unclear how double (or multiple) taxation could be avoided. The secondary rule special measure in Option 5 should accordingly be rejected.

**ii. Answers to framework questions for primary rule in Option 5**

[1] **Efficacy**—normal transfer pricing rules, which would operate before application of the primary rule, and the effective tax rate test (which would have to be determined after the impact of any local country taxes, withholding taxes, and any other gross income
inclusion under a CFC regime with respect to that CFC), would ensure alignment of transfer pricing outcomes and value creation.

[2] **Advantages/disadvantages**—Option 5 recognizes the primacy of a CFC’s home jurisdiction to tax income earned by the CFC. It’s based on a bright-line rule that can be further tailored to encourage or discourage CFC behavior. It directly addresses a primary BEPS concern of double non-taxation of income by ensuring a minimal level of taxation of CFC income.

[3] **Likely effect**—the primary rule would likely encourage behavioral changes, depending on the criteria used to trigger income inclusion (and taxation) in the parent jurisdiction. The primary rule as proposed would, for example, encourage operations in CFCs in jurisdictions such that the effective tax rates exceed the specified threshold.

[4] **Adaptation of TP rules**—as the primary rule would operate after application of the normal transfer pricing rules, no adaptation of such rules is needed.

[5] **Targeting**—Option 5 targets a primary BEPS concern of double non-taxation of CFC income. The measure provides a bright line rule for its application, based on effective tax rates, using a well-established approach. Agreement among tax administrations is unnecessary; only the tax administration in the ultimate parent’s jurisdiction is concerned with criteria for application—the tax administration in the CFC jurisdiction is unaffected.

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[6] **Tax advantage**—the measure makes no reference to tax attributes; criteria shouldn’t be included limiting the measure to circumstances where the arrangement results in a tax advantage to the group.

[7] **Ordering**—the measure should be applied after application of the normal transfer pricing rules.

[8] **Eliminating double taxation**—double taxation is unlikely to arise because (1) normal transfer pricing rules apply first (with a relatively low risk of resulting in double taxation); (2) the comprehensive approach mentioned above to determine the CFC’s effective tax rate; and (3) the tax credit mechanism in the parent jurisdiction should mitigate double taxation.

[9] **Excluding sectors**—no sectors should be excluded from application of the measure.

2. **The special measures in Options 2–4 should be rejected**

   a. **Options 2 & 3, targeting capitalization of subsidiaries**

   Some comments are warranted relating to the preamble to Options 2 & 3. The BEPS Action Plan called for “transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has . . . provided capital.”\(^{30}\) The BEPS Action Plan thus signaled concerns about returns accruing to an entity that neither assumed risks nor performed functions relating to intangible property. By contrast, the *Actions 8–10 PDD* asserts, that “[t]he BEPS Project . . . sets out the need to consider the potential for inappropriate returns for providing capital.”\(^{31}\) The *Actions 8–10 PDD* thus inexplicably broadens the scope of

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\(^{30}\) BEPS Action Plan, Action 9 (emphasis added).

\(^{31}\) *Actions 8–10 PDD*, p. 42.
the BEPS Action Plan special measure relating to capitalization, suggesting use of such a special measure even if an entity bears risks and performs functions relating to intangible property. The Actions 8–10 PDD asserts that application of [presumably, normal] transfer pricing rules “may determine that little or no return is due to a capital-rich, asset-owning company,” but that “[i]n 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.”

The thrust of this seems to be that the called-for special measure can be used by tax administrations to get tax revenue if normal transfer pricing rules fail to get it. It’s unclear what “excess” returns are—do they relate to residual returns earned by a capital-rich, asset-owning company after applying normal transfer pricing rules, or perhaps even to returns earned by such a company if the arm’s length principle is “difficult” to apply? “Unanticipated” returns presumably relate to hard-to-value intangibles, so can be dealt with using a suitably crafted variation of Option 1, as discussed above.

Options 2 & 3 should be rejected. Neither Option could be justified under the ALP.

Option 2 targets “circumstances where a capital-rich, asset-owning company depends on another group company to generate a return from the asset.” It proposes using as its touchstone an “independent investor” who considers which of the two companies offers a better investment opportunity, “taking into account expertise in conducting risk managed activities to generate a return on the investments and the level of risk and potential return.” It’s unclear how this constraint would apply in any fact pattern. How are the investment opportunities precisely to be determined? If the special measure is triggered, how much capital is deemed contributed to

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32 Id. (Emphasis added).
the company providing the more rational investment opportunity? Is the capital-rich company entitled to keep any capital, and if so, doesn’t the same difficulty in choosing an “acceptable level” of capitalization arise? In a situation involving an asset-rich company owning many assets, how would its capital to be apportioned among its assets?

In any event, Option 2 seems designed to skew the result to yield an outcome favoring investment in companies performing functions rather than owning assets and bearing risks associated with those assets. There’s certainly no economic policy justification for an independent investor ignoring assets, and the bearing of risks associated with those assets, in favor of the performance of activities relating to the exploitation of any of those assets. An unconstrained investor might well choose to invest in a capital-rich, asset-owning company rather than a company used to generate returns from the assets on the grounds that the functions performed by the latter company—e.g., manufacturing and sales—generate only routine returns.

Aside from the lack of clarity and questionable policy underpinnings of Option 2, it suffers from lack of practicability. It focuses on an asset-by-asset approach. The determination of the deemed capital contributions would be exceedingly difficult in any situation in which many group companies perform activities relating to generating returns from a broad portfolio of intangibles. This would be the case with most large multinational enterprises.

Option 3 hinges on determining a level of “thick capitalisation.” But there’s no generally agreed-upon level of capitalization of a company, nor how one would choose criteria to determine the level to use. Option 3 is also opaque on which company would be treated as providing the excess income—is it the immediate, or ultimate, parent?
b. **Option 4, targeting minimal functional entities**

Option 4 proposes a special measure focusing on a threshold level of functionality in an entity that, where lacking, would cause the profits of that entity to be reallocated. This special measure should be rejected.

The TPG would allocate profits among associated enterprises in part according to the risks they bear and the functions they perform; in particular, functions relating to the development, enhancement, maintenance, protection, or enhancement of intangible property. Option 4 asserts that if one of the associated enterprises is a “minimal functional entity” then “[i]t may prove simpler and more effective” to adopt the special measure. Does this mean the special measure would be applied instead of normal transfer pricing rules in the TPG? If so, it amounts to a type of profit-split / formulary apportionment depending entirely on functions performed—such an approach was rejected in the TPG “in theory, implementation, [and] practice.” 33 If the special measure was intended to be applied following application of the normal transfer pricing rules, it would amount to an excessive weighting placed on functions for allocating profits, to the detriment of risks and assets.

The proffered thresholds are problematic. The qualitative threshold mirrors a situation in readily addressed under the normal transfer pricing rules of the TPG, so it’s unclear that this approach is “simpler and more effective” than the TPG. A desire for simplicity does not justify departing from analyzing the facts and circumstances under the ALP. The quantitative thresholds are equally troublesome. An entity performing mainly routine functions with a small number of employees would likewise be unlikely to earn much profit based on those functions

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33 TPG, ¶¶ 1.15–1.32.
under normal transfer pricing rules. The fact that “[a] substantial part of the company’s income is from arrangements with group companies” says nothing about functionality within the entity, even assuming that’s a valid criteria on which to solely special measure (it’s not). Likewise, looking at the ratio of a company’s assets to income, or its capitalization, says nothing about functionality.

Regarding reallocation of profits if the threshold wasn’t met, it’s unlikely that a “predetermined factor” could be agreed upon for purposes of the “mandatory profit split” variant for allocating profits. The same concerns voiced in the TPG’s rejection of formulary apportionment are relevant here.34

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34 E.g., “Even if some countries were willing to accept global formulary apportionment, there would be disagreements because each country may want to emphasize or include different factors in the formula based on the activities or factors that predominate in its jurisdiction. Each country would have a strong incentive to devise formulae or formula weights that would maximise that country's own revenue.” TPG, ¶ 1.23.
February 6, 2015

The SVTDG is composed of representatives from leading high-technology companies with corporate offices predominantly located in the area between San Francisco and San Jose, California (widely known as the "Silicon Valley"). It was formed in 1981 and now has 81 members (a list is available at http://www.svtdg.org/members.php).

The purpose of the SVTDG is to promote sound, long-term tax policies that support competitiveness. Members of this group believe that tax policies should enhance opportunities for productivity growth by encouraging and rewarding enterprises that develop goods and services that meet international market standards. The companies represented by the group are dependent on research and development in order to remain on the cutting edge of technology innovation and to compete in the international market place.

The SVTDG shares the views set out in the attached letter regarding BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures) and urges that they be given consideration.

Sincerely,

[Signature]
Jeffrey K. Bergmann
Co-Chair, Silicon Valley Tax Director’s Group
February 6, 2015

TechNet is the national, bipartisan network of CEOs and senior executives that promotes the growth of the technology industry by building long-term relationships between technology leaders and policymakers and by advocating a targeted policy agenda at the federal and 50-state level. TechNet’s diverse membership of over 60 companies includes dynamic startups to the most iconic companies on the planet and represents more than two million employees in the fields of information technology, biotechnology, green tech, e-commerce, venture capital and finance. TechNet has offices in Washington, D.C., Silicon Valley, Sacramento, Seattle, Boston and Austin.

TechNet’s membership can be found at: http://www.technet.org/leaders/member-companies/

TechNet shares the views set out in the attached letter concerning BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures) and urges that they be given consideration.

Sincerely,

Michael Ward
Vice President, Federal Policy and Government Relations
mward@technet.org
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29. Gilead Sciences, Inc.
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32. Hewlett-Packard Company
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34. Intuit Inc.
35. Kleiner Perkins Caufield & Byers
36. Lee & Hayes, pllc
37. LiveOps, Inc.
38. Lyft, Inc.
39. Madrona Venture Group
40. Marvell Semiconductor, Inc.
41. MHR International, Inc.
42. Microsoft Corporation
43. MIND Research Institute
44. Morgan Stanley
45. Motor Vehicle Software Corporation
46. NASDAQ OMX Group, Inc.
47. OpenDNS, Inc.
48. Oracle Corporation
49. Palantir Technologies, Inc.
50. Perkins Coie LLP
51. Pfizer, Inc.
52. Point Inside, Inc.
53. Qualcomm, Inc.
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55. Revolution LLC
56. salesforce.com
57. SAP
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69. Yelp Inc.
5 February 2015

Via E-Mail
TransferPricing@oecd.org

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OECD Discussion Draft: BEPS Actions 8, 9 and 10 - Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures)

Dear Mr Hickman

The business federation SwissHoldings represents the interests of 61 Swiss based multinational enterprises from the manufacturing and service sectors (excluding the financial sector). SwissHoldings is pleased to provide comments on the OECD Discussion Draft of the Proposed Modifications to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures; hereafter referred to as “the Draft”).

SwissHoldings supports the objective to ensure that transfer pricing outcomes are in line with value creation. However, from the perspective of the taxpayer, the revised Draft should:

1. provide clear and, in particular, practical guidance (and not limit the discussion to new theoretical and complex concepts);
2. be completely in line with the arm’s length principle in order to avoid controversy and double taxation, and
3. limit the additional compliance burden for taxpayers.

Unfortunately, the three key criteria and objectives above are not fulfilled. Therefore, we recommend substantial amendments to the Draft.

Moreover, besides clear rules, the key success factor is consistent application of the new principles by taxpayers and, more importantly, acceptance by all tax administrations.

Further comments on the Draft are provided below.

General Comments

1. We support that transfer pricing outcomes should be in line with value creation. However, instead of providing further guidance on how to improve the transfer pricing analysis and, in particular, the pricing of risk to ensure that transfer prices are in line with value creation, it seems the primary focus of the OECD was to create “BEPS Guidelines” and accept with the current Draft a substantial erosion of the arm’s length principle. Our interpretation is that the new term “in line with value creation” is a synonym for “in line with the arm’s length principle”. A clarification would be welcomed.
2. The Draft includes several new terms and concepts which are not clearly defined. Both aspects will most likely lead to controversy and double taxation for taxpayers.

3. Most of the new concepts (and tests) remain theoretical in nature (e.g., moral hazard, risk-return trade-off, commercial rationality test, etc.) without considering guidance and the ability to implement them in practice. One of the leading principles has been so far that transfer pricing (paragraph 3.55 of current Guidelines) is "... a not exact science...". Moreover, "the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises...". According to the Draft, these principles do not seem to be applicable anymore. It seems that the intention of the OECD is to make an exact science of the complex matter of transfer pricing. However, if taxpayers and tax administrations are not able to understand and apply the Guidelines and new theoretical concepts in practice, it will significantly increase the potential for controversy, double taxation and costs for taxpayers and tax administrations. A clarification that these leading principles are still applicable would be welcomed. Moreover, a simplification of the proposed rules and concepts is required.

4. There is a need to maintain a balance between a more detailed transfer pricing analysis (considering also risk) and the potential compliance burden for taxpayers. Hence, a reduction of complexity and limitation of the compliance burden for the taxpayers is required. In particular, the extensive new transfer pricing documentation requirements just communicated by the OECD should also be considered.

5. Given all the new definitions, concepts and tests to be performed with regard to risk, it would be helpful to clarify that risk is a "comparability factor". As for any comparability factor, transfer pricing adjustments should be performed, if required. This fundamental principle seems to be "hidden" in paragraph 75 of the Draft. Moreover, the Draft clarifies correctly in paragraph 74 that no separate compensation is required for (the not clearly defined term) "risk management", as this is included in the market prices for other transactions. The Draft also has a too isolated view on the risk analysis. Further clarifications would be helpful.

6. We also appreciate the ambition to provide guidance to identify risks. However, if risks are really difficult to identify, as assumed in paragraph 38, then the missing risk category cannot be material enough to be considered in the transfer pricing analysis. It would be helpful to clarify that the risk analysis should be limited to key or material risks and not applied to all (theoretical) risks.

**Actual conduct, commercial rationality test and options available**

7. We support that actual conduct and risk allocation is an important element in the transfer pricing analysis. However, the Draft goes unfortunately beyond mere "sharpening the focus" on conduct. In particular, it should be clarified that contractual obligations and rights between the parties are not only the starting point, but remain one of the main aspects for the transfer pricing analysis. We support that the contract should be supported by actual behaviour of the parties.

8. We also support the theoretical principles that options realistically available should be considered. However, the new "commercial rationally test" as described in section D.4.2 lacks clear practical guidelines. Moreover, it neglects that in most cases within a group, the options realistically available are limited if the - bargaining power - of the respective legal entities within a group is considered. If for instance the principal and IP owner (e.g., HQ) of a transaction decides to relocate certain activities (e.g., contract manufacturing, services, etc.) or risks (e.g., FX) from one (e.g., high cost) country to another to remain competitive, then there is no need to have a theoretical discussion around "options available" and/or whether it
would “offer each of the parties a reasonable expectation to enhance or protect their commercial or financial position on a risk adjusted basis.” Rather, considering the bargaining power and respecting the actual (limited) options considered within a group the taxpayers and tax administration should focus on an arm’s length remuneration for the transaction (transfer of assets or risks) under review. It would be helpful to clarify that theoretical and actually not relevant or considered options are not required to be evaluated and documented. Hence, the Draft should focus on more clear and practical guidance for proper pricing of transactions or risks. Due to the lack of divergence of interests is the behaviour per the definition different within a group compared to transactions with unrelated parties. Hence, the revised guidelines should focus to align the pricing and not artificially the behaviours within a group.

9. The examples and discussions about pre- and post-tax results are confusing, in particular if we consider that benchmarking is usually performed on an EBIT/operating income level. Hence, the new aspects should be dropped to reduce the potential for controversy and double taxation.

10. The theoretical new “behaviour tests” limit the freedom for MNEs to operate. Any limitation is not in line with the arm’s length principle. Moreover, it opens the door for unreasonable challenges by tax administrations considering ex-post information.

Moral Hazard

11. The concept of moral hazard is a complex theoretical concept and very difficult to assess and apply in practice. Independent of the complexity, we are of the opinion that this principle is not relevant in most cases for transactions between related parties and should therefore be completely dropped to mitigate confusion and potential for controversy and double taxation.

Risk-return trade-off

12. We fully support the theoretical concept around the new term “risk-return trade-off”. However, we do not support the implications and unclear guidance provided in the Draft. Moreover, it is difficult, if not impossible, to implement in practice and partly not in line with the arm’s length principle.

13. In particular, we are very concerned about the proposed limitations in doing business within a group. Why should a transaction not be recognised if the sole effect is to shift risks? MNEs are making permanently commercial and financial decisions about risks with unrelated parties, either in conjunction with a special transaction/activity or in isolation. This principle is applicable for all MNEs and not limited to the financial services sector. As such, it is unclear to us why the OECD wants to limit the freedom to operate for MNEs. Any limitations are not in line with the arm’s length principle.

14. In transactions with unrelated parties risk is more likely to be assumed by the party which has the risk appetite and financial capacity to bear it as well as the required substance and not who “controls” or “manages” the risk. This is a fundamental difference in the proper understanding and application of the arm’s length principle. Hence, instead of focusing too much on unclear and non-arm’s length concepts, the Draft should focus more on clearer and practical guidance on how to determine accurate transfer prices, and where required, perform pricing adjustments (on a risk adjusted basis). As a general rule, there is no need to discuss and apply non-recognition or recharacterisation.
15. From an economic perspective, too much emphasis is on the behavioural aspects around risk, which is not in line with the arm’s length principle. Although we acknowledge that actual conduct and control/risk management is an important element and needs to be properly considered in the transfer pricing analysis. But it is not the only aspect and in particular not the main one. Rather, bearing the financial/economic risk (funding) and capacity to do so (including having the required substance) remain the key elements at arm’s length. This is another fundamental difference in the proper understanding and application of the arm’s length principle. As stated above, MNEs are making decisions about risk (allocation) with unrelated parties and the risk management capabilities of the counter party is usually not a key factor. This is especially true if we consider the limited information available to both parties. With unrelated parties, the focus is primarily adjusting the (market) prices to reflect the adjusted risk allocation.

16. The newly introduced terms and concepts about “control” and “risk management” are not clearly defined and might result in controversy and double taxation. Alignment with the intangibles paper is required. A further clarification and reduction in complexity is welcomed.

Part II. Potential Special Measures

17. With clear and practical guidance to properly apply the arm’s length principle, there is no need for further guidance on non-recognition, recharacterisation and in particular special measures.

18. Also, considering the extensive new transfer pricing documentation requirements, there is no need for further adjustments and new concepts as information asymmetry between taxpayers and tax administrations does not exist anymore or at least will be reduced significantly. Hence, before additional measures and concepts are implemented, which are not in line with the arm’s length principle, we recommend to first assess the efficiency and impact of the existing activities.

19. If at all, it should be considered with the other actions (e.g., CFC rules) as all proposed measures have nothing to do with the arm’s length principle and would lead to double taxation.

20. Considering also that transfer pricing is not an exact science, appropriate pricing adjustments always need to be used before any non-recognition and/or special measures are considered. Appropriate additional measures to avoid double taxation need to be implemented.

21. Moreover, as applicable for any guidance, clear definitions and practical guidance must be provided to ensure a consistent and efficient application.

Hard-to-value intangibles

22. The term Hard-to-value intangibles (HTVI) is not clearly defined. Without a clear definition, the implementation will fail and lead to controversy and finally double taxation. Sufficient guidance is provided in the revised Guidelines for Intangibles.

23. Moreover, with unrelated parties, the proposed price adjustment mechanism is the exception and not the rule, in particular long term. Hence, making the exception to the rule for MNEs is not arm’s length and must therefore be dropped. However, as an alternative, if taxpayers are choosing this optionally and properly documenting the chosen set-up, then this must be respected by the tax administrations.
Inappropriate returns for providing capital

24. We are not clear about the example for “inappropriate returns for providing capital”. If it is obvious that the actual returns are not appropriate for the provided capital, then corresponding transfer pricing adjustments should be performed. Hence, there is no need to discuss at all special measures.

Minimal functional entity

25. The definition of a “minimal functional entity” is not clear. Is this a routine entity with a limited function and risk profile and typically benchmarked on a TNMM basis? If the transfer pricing analysis determines that the entity under review has “minimal functions”, then it should be able to determine an appropriate benchmark for such an entity. If required, additional transfer pricing adjustments should be performed.

26. The application of proposed functionality thresholds is not in line with the arm’s length principle and should be avoided. The same applies to the mandatory application of the profit split method based on pre-determined factors.

27. Instead, we would support the application of safe harbour rules as proposed in the draft guidelines for low-value adding services for “minimal functions” entities, respectively, routine entities.

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We kindly ask you to take our comments and proposals into due consideration.

Yours sincerely

SwissHoldings
Federation of Industrial and Service Groups in Switzerland

[signature] [signature]
Christian Stiefel Dr. Martin Zogg
Chair Executive Committee Member Executive Committee

cc - SwissHoldings Board
- Nicole Primmer, Senior Policy Manager, BIAC
- William Morris, Chair of the BIAC Tax Committee
- Krister Andersson, Chair BUSINESSEUROPE Tax Policy Group
Andrew Hickman
Head, Transfer Pricing Unit
Centre for Tax Policy and Administration
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Paris, France

Via Email: transferpricing@oecd.org

RE: Public Discussion Draft on BEPS Actions 8-10: Revisions to Chapter I of the Transfer Pricing Guidelines

Dear Mr. Hickman:

On 19 July 2013, the OECD published an Action Plan on Base Erosion and Profit Shifting (hereinafter the Action Plan or the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries’ tax bases are being eroded or profits shifted improperly. Pursuant to Actions 8-10 of the Plan, on 1 December 2014 the OECD published a public 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) (hereinafter the Discussion Draft or Draft).

The OECD solicited comments from interested parties no later than 6 February 2015. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD’s request for comments. In addition, TEI requests the opportunity to speak in support of these comments at the public consultation meeting regarding this Discussion Draft, scheduled for 19-20 March 2015 in Paris.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws,
TEI Comments

General Comments

TEI commends the OECD for its theoretically sound discussion of transfer pricing principles and analysis as set forth in the Discussion Draft. We concur that it is essential for multi-national enterprises to correctly identify and weigh the economic value of functions and risks of each activity in the framework of their value chain. This review should be done on a regular basis since businesses are usually not static.

As MNEs become more globalised and integrated and supply chains become more complex, it is becoming extremely difficult to determine where functions and risks lie and to monitor operations without expending substantial time, effort, and resources. For efficiency, many companies operate as if there are no borders and no separate statutory entities. Similarly, many functions are managed centrally and on a global basis while others may be managed locally or, in many cases, there may be a combination of both. Therefore, it is extremely difficult to find knowledgeable resources that can help determine functions and risks from a tax perspective since an MNE’s management structure may be quite different. To do transfer pricing analyses at the level of detail that is discussed in the paper would require an enormous amount of resources from both tax authorities and taxpayers.

A correct application of the arm’s length principle commands first an understanding of the value drivers of the group as a whole (a holistic approach) and the relevant risks involved from both a short- and longer-term perspective, as well as how responsibility for those risks is shared among the participants. In general, the shift to more economic and holistic analyses will downplay the importance of pure transactional analyses. On the other hand, the transfer pricing guidelines continue to focus essentially on testing intercompany prices and not the setting of such prices. In the reality of MNEs, transactions are driven by the business model and the relations between the related companies. The transfer pricing guidelines should reflect this shift and be less demanding of MNEs on the transactional side as they have spent a significant effort in documenting their price setting.

The first paragraph of the Discussion Draft refers to two key aspects of the comparability analysis at the heart of the arm’s length principle: (i) accurately delineating the actual transactions, and (ii) comparing the conditions of the controlled transaction with the conditions of uncontrolled transactions. This is reminiscent of the two-step approach under

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1 TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).
Article 7 of the OECD’s Model Tax Convention on Income and Capital (Model Convention), regarding attribution of profits to permanent establishments. The authorised OECD approach (AOA) to such attribution adopts a similar two-step method. The circumstances under Article 7, however, are different from those under Article 9 Associated Enterprises because under Article 7 the goal is to allocate profits between a company and the company’s permanent establishment. The similarity between the AOA and the Discussion Draft raises the question of the extent to which the OECD envisages merging the approaches under Articles 7 and 9. The OECD should explicitly set forth its intent in this regard.

The text of the proposal refers to “conduct of the parties” in many places. Analysing the conduct of the parties can be difficult, however, and thus is subject to different interpretations and views, much more so than the written agreements that underlie the contractual arrangements. In today’s world, companies operate through multiple layers of decision-making. Management teams are not generally located in a single jurisdiction but instead are spread across the globe and the process of determining the conduct of the parties is not as straightforward as it once might have been, especially for a single tax authority. This presents the possibility of creating wide differences between the taxpayer’s and tax authority’s view of an MNE’s transfer pricing processes, leading to potentially substantial tax adjustments by authorities, which may then lead to double taxation if a second jurisdiction takes a different view of the parties’ conduct.

As MNEs become more integrated globally, and supply chains become more complex, we therefore believe it is important to limit the economic analysis to the core functions and risks at stake in the business for materiality reasons and administrative efficiency. Moreover, the economic analysis should not downplay the importance of contracts. Paragraph two of the Discussion Draft refers to how entities in an enterprise

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.

While the reference to value generated by associated enterprises is welcome, the interpretation of the intercompany contracts between the associated enterprises should lead the analysis.

The workload of transfer pricing justifications should remain balanced and workable for the taxpayers, i.e., it should not be overwhelming burdensome, expensive, and time consuming for MNEs and also for tax authorities. Practically, the OECD should invite the governments to abandon or dramatically relax the punitive penalties raised in case of so-called “insufficient” transfer pricing documentation for at least the five years following the implementation of the new guidelines.
In the end, legal security and an affordable compliance burden are the most important parameters for an efficient transfer pricing regime in the view of MNEs. If the OECD adds additional burdens without relaxing other rules, it will create additional confusion and new entry barriers for international business. Finally only very large and well organised MNEs will be able to afford those additional burdens.

Specific Comments on the Discussion Draft

Identifying the commercial or financial relations (par. 1–15)

TEI agrees with the OECD recommendation that, when applying the arm’s length principle, the process of identifying the commercial or financial relationship between associated enterprises follows from examining the contractual terms governing such relationship together with an analysis of the actual conduct of the parties. It is critical to start from the contractual analysis because it sets forth the formalised legal relationship among the members of an MNE that are used to conduct the MNE’s worldwide operations. Of course, the formal contractual relationships between members of the group can be overridden or outweighed by the tax authorities when the factual substance of the contracts and actual conduct of the parties differ from the contractual terms. For the sake of efficiency and good tax administration, we recommend creating a rebuttable presumption in favour of the taxpayer that contractual arrangements reflect the underlying reality of an MNE’s operations. The burden of proving the contrary would then fall on the tax administrator.

With respect to the example in paragraph 6 of the Discussion Draft, it is TEI’s view that the example does not properly illustrate the OECD’s message regarding non-recognition / recharacterisation. The license agreement for the use of Company P’s intangibles along with technical support provided by Company S should not be ignored or treated as if it does not reflect the “actual transaction” between the two companies simply because Company P also provides support to Company S in its contractual negotiations with clients. Facilitating the business of Company S is obviously in the economic interest of Company P since the royalty is likely to be an ad valorem fee based on the gross revenue realised by Company S. In other words, there are countervailing considerations that might lead Company P to act in the manner described in the example that should be taken into account.

Paragraph 14 of the Draft concludes with the statement that “in no event can unadjusted industry average returns themselves establish arm’s length prices.” This statement is too absolute. A goal of the arm’s length principal is to replicate the price that would have resulted between unrelated parties. Thus, it would seem that a return in line with industry averages would be substantial, but not conclusive, evidence that a price was arm’s length. Further, industry averages may be particularly relevant when information about comparable individual unrelated parties is not available, and thus benchmarking is performed for businesses in the same or similar geographic location operating in the same industry (i.e., in such a case, all
players can be reasonably expected to encounter the same issues and business environment and therefore operate in a similar manner with similar profits). Of course, proper adjustments should be made to increase the comparability of a related party transaction to the third party range. An attempt to recreate a “perfect” comparable in pursuit of the arm’s length principle may lead to simulating a non-existent product or market that deviates substantially from the arm’s length price in a manner that is more drastic than simply using industry averages.

*Options realistically available (par. 16 – 23) – Fragmentation (par. 21) – Recharacterisation - Non recognition (par. 83 – 93)*

Paragraphs 17 and 21 describe differences between services provided between related parties and unrelated parties. It is unclear what the OECD intends by pointing out these differences. In the broader economic context, internal services are always different from services between unrelated parties. Bringing the analysis of economic circumstances of the commercial and financial relations to an unprecedented level of detail, which needs to be reflected or adjusted for, may turn the application of the arm’s length principle into a completely theoretical exercise. The basis for the arm’s length principle is, and needs to be, in a comparison of controlled transactions with transactions between uncontrolled parties.

In its prior work on transfer pricing matters, the OECD confirmed that MNEs had the freedom to structure their worldwide operations as they wish, subject to the constraint that any transactions between associated enterprises satisfy the arm’s length principle. Moreover, the OECD has confirmed that this view should continue to hold no matter the complexity and sophistication of an MNE’s operations and internal structure. This is appropriate as globalisation has rapidly transformed the worldwide economic scene into a polycentric world in which complexity is inherent due to the diversity of MNE operational structures. This is in part a result of the substantial increase in the diversity of an MNE’s global customer base and workforce. To effectively serve such a heterogeneous customer base, manage a highly multicultural workforce, and navigate the varying (and at times inconsistent) jurisdictional rules represented by the countries in which an MNE has such customers and employees, MNEs need to continuously juggle and adapt business models, organisational practices, conflicting compliance requirements, and management structures. These organisational practices include outsourcing and specialisation, which are a subset of globalisation and reflect the need to optimise business practices in a cost efficient manner. Thus, it is misleading to convey the message that complexity is primarily, or even substantially, driven by tax planning. Tax Directors are not in the business of making their tax structures more complex, but instead strive to align their tax planning on the changing business reality.

The Discussion Draft retains the requirement that any transfer pricing analysis should consider “options realistically available” to all parties to the transaction. In other words, the Draft suggests that tax authorities apply a systematic two-sided transfer pricing analysis in which the alternatives of each related party are considered. MNEs, however, usually employ a
common business model, brand, and strategy and are naturally bound by long term relationships. Some MNEs have adopted a centralised business model (Principal) and have concentrated most of the risks and important functions in a limited number of companies with other affiliates performing routine and low risk activities.

In many cases, therefore, the options realistically available for affiliated companies are very limited, as would be demonstrated by a holistic or group value chain analysis. The OECD recognises this in the Discussion Draft and notes that the options realistically available to an associated enterprise in, e.g., the logistics business that services an MNE may differ from those of an independent company, and also recognises that this difference does not mean the MNE’s arrangements are not at arm’s length. Nevertheless, the Draft requires that realistically available options be considered as part of the transfer pricing analysis. In TEI’s view, entities that perform routine and low risk functions should not be required to consider “options realistically available” as part of the transfer pricing analysis.

For the same reasons, the suggestion of non-recognition / recharacterisation of some intercompany transactions if the transactions at issue are odd, rare, or complex should be abandoned. In that regard, in TEI’s view the example of the transfer of a valuable trademark between group entities in paragraphs 90-92 does not provide a correct illustration of the non-recognition concept. In the example, a wholly owned subsidiary of Company P (S1) transfers a valuable trademark that is the key to its business strategy to another wholly owned subsidiary of P (S2), in exchange for a lump sum payment from S2. S1 then licenses the right to use the trademark in its business from S2 in exchange for a royalty. The Discussion Draft states that the 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.”  

What is missing from the example is that it is good business and legal practice for an MNE to centralise the ownership of core intangibles in a single entity (S2 in the example) and to subsequently restructure the intercompany licensing and related services agreements based on this model. Since the price of the transferred intangibles and the royalty rate are arm’s length in the example, there should be no room for non-recognition / recharacterisation of the initial transaction since the arm’s length principle has been fully respected. Moreover, the example ignores other tax consequences, such as income recognised by S1 upon payment of the lump sum, amortisation of the lump sum price by S2, withholding taxes that may be imposed on the royalty payments, as well as the associated foreign tax credits. What happens to these very real tax consequences if the transaction is subject to non-recognition or recharacterisation?

When the contractual framework (even a complex one) decided by the parties has been fully respected in light of their actual conduct, and the prices were set at arm’s length, the concept of non-recognition does not add anything to the debate. Instead, it mangles the

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2 Discussion Draft, p.27.
coherence of the OECD’s transfer pricing guidelines and provides tax authorities with an all-purpose tool to upset the tax effects of an MNE’s legitimate commercial structure. While the Discussion Draft takes pains to note that a transaction engaged in by associated enterprises that does not, or only very rarely, occurs between unrelated parties, should not be recharacterised for that reason, the Draft nevertheless conveys the message that unusual transactions or business models may be evidence of tax avoidance schemes subject to recharacterisation. Indeed, the example used is not unusual at all, but instead involves what appears to be a typical method by which associated enterprises centralise intellectual property ownership.

In very exceptional cases where the contractual terms are not respected by related enterprises, there may be room for recharacterisation and only if the transfer pricing at stake does not reflect arm’s length pricing. But in TEI’s view this type of assertion does not have a place in general transfer pricing guidelines (as opposed to a specific discussion focused on abuse) because it will create confusion and invite overuse (or abuse) by tax authorities.

In terms of examples, TEI suggests that this section include an example of a centralised principal business model that would be respected for transfer pricing purposes.

**Country comparability analysis (par. 29 – 30)**

Even in cases where a single country comparability analysis would be more meaningful, the OECD needs to recognise that it is an option that is mostly unworkable in the real world due to the difficulty in many countries of obtaining reliable company information and/or of finding a sufficient number of reliable comparables. The level of increased sophistication and complexity required by the new transfer pricing guidelines does not support a single country approach. We therefore recommend that the OECD support a multiple-country comparability analysis as a primary principle and abandon paragraph 30.

**Market penetration (par. 35)**

This paragraph states that it is certainly the case that a business strategy, such as incurring losses in an attempt to penetrate a new market, can fail and thus the strategy should not be ignored just because of the failure. However, the paragraph goes on to state that a strategy can be ignored if the business strategy was “implausible” at the time it was entered into or “continued beyond what an independent enterprise would accept . . . .” It is unclear, however, how a tax authority can judge the length of time an independent party would continue an unsuccessful (loss-making) business strategy. For example, in the automotive industry the attempt to develop marketable and profitable electric or fuel-cell powered vehicles continues despite significant loss making for more than two decades (if not longer), and yet companies persist with the strategy and continue investing as they (and it seems society as a whole) believe that it is the future and at some point it will become profitable.

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3 Discussion Draft, p.12.
Financial capacity to bear risk (par. 66)

Paragraph 66 states that “[f]inancial capacity to bear risk is a relevant but not determinative factor in considering whether a controlled party should be allocated a risk return.” In this regard, in TEI’s view, bearing the funding risk for development of intangible assets or any kind of other business development through equity or external loans indicates that the funder is the highest risk taker and has ultimate control over the risk. Moreover, in a market economy, funding normally coincides with risk-taking. Depending on the circumstances, the anticipated return on capital invested in business development should be the same as for a venture capitalist, i.e., an exceptional return or a complete loss. Thus, while financial capacity to bear a risk should not be considered determinative in all cases, it is entitled to more weight than just “a factor.”

Identifying risks in commercial or financial relations - Control over risk - Moral hazard

Within an MNE, core risks may be explicitly transferred between related entities. This takes place, for example, in the creation of principal or principal-led business models. In the market economy, there are also independent enterprises that take on limited risks. There are many types of risks. We believe that the most important risks to capture in a transfer pricing analysis are the strategic and financial risks. Because of the matrix organisations in place in many MNEs, operational and hazard risk can be spread across the organisation and are not generally of sufficient importance in the value creation and risk mitigation to warrant significant analysis.

When defining the roles and responsibilities of group companies, entities or activities under a functional analysis, TEI recommends an approach that uses the relevant responsibility/risk profile of each activity, such as an investment center, profit center, revenue center, or cost center. Understanding the profile of an entity will assist in applying a proper transfer pricing analysis.

Risk-return trade-off

Paragraph 71 states, “In risk transfers between associated enterprises, the risk-return trade-off should not be used on its own to justify the appropriateness of any risk transfer. In particular, a risk transfer not supported by functions should be critically reviewed.”

We disagree with this statement because it does not respect the arm’s length principle. Risks can be transferred within MNEs. The risk-return trade-off is driven by the risks, long term relationships, and bargaining power of each party in the transaction. The value chain analysis followed by a functional analysis should enable the arm’s length principle to allocate risks and rewards among the various actors.
Special Measure Options

Option 1 – Hard-to-value intangibles. TEI recommends that the OECD provide examples of a reasonable contingent payment mechanism as a way to assist taxpayers in their understanding of what is required to avoid the application of this special measure. Also helpful would be the introduction of a safe-harbour, which would prevent tax authorities from applying hindsight to adjust the pricing of transactions involving hard-to-value intangibles. A safe harbour rule could provide protection from hindsight if (i) a reasonable contingent payment mechanism is in place and (ii) the taxpayer had made a reasonable effort to make reasonable assumptions and projections and maintained contemporaneous documentation.

Inappropriate returns for providing capital. The transfer pricing guidelines presume that MNEs have the freedom to control their financing/capitalisation. The guidelines also assume that MNEs can arrange their own financing and allocate risks between related entities. The OECD discussion draft under BEPS Action 4 regarding interest payments proposes limiting the amount of inter-company interest an MNE can deduct to net interest expense paid to external parties, which would be allocated among related entities based on certain allocation keys. One question that arises is that if the interest limitation rule applies, would the taxpayer still be required to conduct a transfer pricing analysis on its inter-company interest charges? That is, if an entity could bear only €50 of interest expense under a transfer pricing analysis, but is allocated €100 of interest expense pursuant to the limitation method implemented under BEPS Action 4, could the entity deduct the greater amount or would it be limited by the arm’s length principle to the lesser amount? In TEI’s view, the taxpayer should be able to deduct the greater amount under interest deduction limitation rules no matter what result would apply under the arm’s length principle. Moreover, the taxpayer may be forced to rearrange its financing to mitigate non-deductible interest, which may have little to do with what an unrelated party might undertake because it may not be under the same restrictions. Finally, it would be useful if the OECD provided examples, guidelines, or parameters regarding what constitutes an “appropriate return” as well as an “inappropriate return.”

Option 3: Thick capitalisation. TEI commends the OECD for considering options that offer ease of application and possible additional certainty. How would this option deal with situations where the deemed interest income is allocated to a country which is different than the company providing functional capacity? For example, assume Company P (parent) is also an operating company, provides capital to S1, which uses the capital to acquire intangible assets (for example, trademarks). In addition, assume S1 has a small number of employees who perform mainly routine functions. Now assume S2 performs many of the functions associated with exploiting the trademarks and managing the risks of these trademarks, under contract basis for S1. Based on Option 4 principles, the intent would be to allocate some of the profits to S2 based on functional capacity. However, based on Option 3 there may have already been a deemed interest income allocation to Company P. How does the OECD propose to address this interaction specifically, as well as between the different special measures generally?
Option 4: Minimal functional entity. We note that paragraphs 55-57, which discuss risk management, would grant tax authorities the ability to challenge any limited function and risk profile on the basis that they have an operational risk element (raw material prices, etc.), even though eventually such entity may be fully compensated by the Principal. It would be helpful to provide a more nuanced discussion respecting the diversity of business models and their respective operational and risk frameworks.

With respect to Option 4, the proposed special measure does not achieve its policy goal because there is no such thing as a “minimum level of functionality” in the market economy. Functional analyses and risk profiles will dictate the functionality of each entity. The financial functionality (or financial capacity to bear risk) – contrary to what is suggested under paragraph 66 — is a determinative factor in considering whether a related affiliate should be allocated a risk return. As such, this measure has only disadvantages and will lead to artificial “minimum level of functionalities” disconnected from the type of industry and the size of the taxpayer.

Option 5 – Ensuring appropriate taxation of excess returns. TEI notes the following issues that should be taken into account in any special measure that address the taxation of excess returns. First, if the percentage of the controlled foreign corporation’s (CFC) average effective tax rates is to be used to ensure an appropriate amount of tax is paid, some mechanism should be developed to adjust the rate for tax loss carryforwards or carrybacks, as well as specific tax incentives. Second, the guidance should address which company’s financial reporting rules to use when determining the CFC’s average effective tax rate. In general, it would make sense to use the parent company’s rules if the CFC average effective tax rate is to be compared to that of the parent. Third, who would remit the additional tax that would be assessed, the parent or the CFC? Who has legal liability for such a tax?

In addition, if the CFC was dealing with various different related entities, it would make little sense to compare its average effective tax rate to the parent. Would the CFC be required to analyse a separate average effective tax rate for each related entity and compare that to a percentage of each related entity’s tax rate, and if it is below that threshold, the related entity would be required to pay the tax? Earnings volatility presents another complication – would a CFC be permitted to track the excess returns over time and get credits or a refund if, in another year, there is too little return?

The application of primary and secondary rules can get quite complex and would be quite burdensome especially in cases where MNEs have many entities. TEI recommends the OECD consider options to reduce this complexity, such as granting MNEs the ability to group companies in the same tax jurisdiction and safe harbour or de minimis rules (e.g., if an entity has less than a certain amount of sales or assets, then the analysis would not need to be conducted).
Conclusion

TEI appreciates the opportunity to comment on the OECD Discussion Draft regarding proposed revisions to Chapter I of the OECD transfer pricing guidelines under BEPS Actions 8-10. As noted, TEI requests the opportunity to speak in support of these comments at the public consultation in Paris on 19-20 March 2015.

These comments were prepared under the aegis of TEI’s European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of TEI’s legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.

Mark C. Silbiger
International President
Amsterdam, 9 February 2015

Subject: Comments on the Public Discussion Draft which deals with work in relation to BEPS Action Plans 8, 9 and 10 (“Assure that transfer pricing outcomes are in line with value creation”)

Dear Mr. Hickman,

TPA is pleased to contribute through this representation to the valuable work performed by the OECD on the “discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures)”, published on 19 December, 2014 (hereinafter, the “Report”).

TPA and its Global Alliances would like to congratulate the OECD with the progress being made on the revision of Chapter I of the OECD Guidelines.

TPA hereby presents its comments and suggestions on the proposed revision to Chapter 1, Section D of the Transfer Pricing Guidelines in the following order:

- Identifying the commercial or financial relations (see Section I);
- Risk (see Section II);
- Non-recognition (see Section III); and
- Comparability adjustments (see Section IV).

Yours Sincerely,
Steef Huibregtse
On behalf of TPA Global and its Alliance Partners
TPA’s Comments on the Public Discussion Draft which deals with work in relation to BEPS Action Plans 8, 9 and 10 (“Assure that transfer pricing outcomes are in line with value creation”)  

1. Identifying the commercial or financial relations (D.1)  

I. General comments on paragraphs 1 through 15 of the Report  

The base concept of Article 9 of the OECD Model Tax convention is that associated enterprises can enter into an intercompany agreement defining terms and trade. The authorities will principally honour such agreements, unless the conduct of parties significantly deviates from the allocation of functions / risk / asset under the agreement. Paragraphs 2 and 3 of the report seem to suggest that “agreement” and “conduct” are 2 equal criteria to measure “at arm’s length” behaviour. TPA suggests re-stating the hierarchy as before, since an implicit shift of the burden of proof is otherwise the consequence of the stated and revised principle under paragraphs 2 and 3 in this Report. The approach by tax authorities might change due to this, i.e. what used to be a marginal check on conduct of parties will become a series of judgments on how parties “should have entered into the intercompany transactions”. The type of suggestion made in paragraphs 2 and 3 implies “motive testing”, for which the OECD nor tax inspector has a legal base.  

2. TPA’s comments on modification of paragraph 1.34 of the OECD Guidelines (paragraph 12 of the Report)  

In case – as paragraph 12 of the Report suggests – taxpayers do treat each individual transaction as an investment looking at all realistically available options, each entrepreneurial step which is not fully documented becomes suspicious. Since we know entrepreneurship is a combination of knowledge/ rationale and intuition / emotions, it will be impossible to comply with such a suggested approach.  

The concept of “opportunity cost” is given a different interpretation by OECD than in standard literature, i.e. OECD suggests that taxpayer needs to “seek an alternative that offers a better opportunity”. TPA recommends that OECD takes a more realistic view on how businesses are run in order to avoid that tax inspectors apply an integral testing of the MNEs business model or business opportunities. A fair balance between running and managing a business and creating audit trails for TP purposes should be the guidance for OECD and taxpayers.  

The implication of the OECD suggestion on audit trails on “realistically alternative options” is that it injects “agency cost” back into the MNEs, which defeats the purpose of an MNE, i.e. eliminating “agency cost” from its value chain.  

3. TPA’s comments on functional analysis (paragraphs 16 through 23 of the Report)  

Paragraph 18 seems to suggest that the geographical spread or diversity of assets would grant each subsidiary with an explicit insurance benefit of being diversified, i.e. according to the report, such a benefit should be granted back to the policy holders.
We do believe the way OECD draws a comparison with the insurance industry is not correct, i.e. a diversification at the level of the insurance company only leads to rebates if / insofar it provides the insurance company a significantly better (read: lower) cost of capital.

It puts centralized insurance companies set up by MNEs under the same “economical approach” comparable to “centralized purchasing companies”. However, “volume discounts” are not the same variable as “rebates of insurance premiums” both from a functional as well as an industry perspective.

II. Identifying risks in commercial or financial relations (D.2)

4. In its discussion about additional points (p. 14 of the Report), OECD suggests that “moral hazard”, i.e. behavioural aspects of parties relating to risks, could play an important role in analysing the allocation of risks between 2 or more related parties. However, it is not clear how to apply such concept in a functional analysis between group companies. TPA suggests further clarifications.

5. The concept and definitions of operational, strategic and financial risk are explained in paragraphs 41-42, where paragraph 43 seems to suggest that the intercompany agreement is leading in allocating these risks between group companies. It states that only where differences between contract and conduct of parties exist, the parties’ conduct should generally be taken as the best evidence concerning the actual allocation of risk. TPA supports the OECD in this analysis.

6. Paragraph 55 introduces 3 layers of risk management which will require MNEs – beyond the one-dimensional allocation of risks today – to investigate in detail which part of the organisation takes care of each of the 3 layers of risk management. The explicit corporate governance of the 3 layers has not been captured and / or documented at this level of detail within MNEs in today’s economy. Although “being in control” is a major focus of each MNE, the cost and time involved in documenting the 3 layers is considered beyond the regular way of running their business.

Example: 12 R&D leaders within 1 MNE are located in 5 countries, providing management and supervision to 500 R&D knowledge workers. The chair of the R&D committee resides in France. How should the MNE define and allocate the following types of risk management activities:

- Technical product obsolescence;
- R&D pipeline management;
- “Blue sky” research; and
- R&D budget overrun.

7. OECD addresses “actual conduct” in paragraphs 56 – 60, where it opens the opportunity for MNEs to heavily centralize the 3 layers of risk management in a central location, if / insofar such central risk management team has also the capability to assess, monitor, and direct the outsourced measures that affect risk outcomes, together with the performance of such assessment, monitoring and direction (so called “central dashboard” option).

This would mitigate all local operations to be stripped from the “control over risk”. Although not all value chains of MNEs are set up like this, the ones who implement such model will rely on the local operations to be focused on execution of functions rather than any level of involvement of “controlling of risks”.

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III. Non-Recognition (D.4)

8. TPA highly appreciates OECD’s statement made in paragraph 84 on the very limited use of the concept of non-recognition by tax authorities, i.e. a situation where an intercompany transaction may not be seen between independent parties does not mean that it should not be recognized. OECD introduces in the Report the concept of “fundamental economic attributes”, which is defined as “an arrangement between unrelated parties offering 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.

Although TPA recognizes this definition to be relevant, OECD should not consider a “pre-tax basis” as a relevant pointer in isolation. In addition, paragraph 93 suggests applying a “replacement structure” in case of non-recognition of the intercompany transaction as presented by the MNE. TPA believes a “replacement structure” should only be proposed by tax authorities as a “lender of last resort”.

IV. Comparability Adjustments (D.8)

9. Since location savings, other local market features, assembled workforce and synergies cannot be considered intangibles according to OECD, comparability adjustments are indicated to account for such factor in determining the intercompany price. TPA highly appreciates the examples provided by OECD in paragraphs 129 – 138 of this Report. TPA believes that the concept of industry dynamics and bargaining concepts could be added as a further reference on how to apply these comparability adjustments in practice.

Example: a semi – monopolist market place will apply premium pricing to its customer base, irrespective of whether the customer is a third party or a group company. In a full competitive market, these dynamics will favour the customer base, as producers will be forced into a price based on marginal costing.
February 6, 2015

VIA E-MAIL

Mr. Andrew Hickman
Head of Transfer Pricing Unit
Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
2, rue André Pascal
75016 Paris, France

Re: Treaty Policy Working Group Comments on Risk and Recharacterization Issues - BEPS Discussion Draft on Actions 8-10 and on Special Measures

Dear Mr. Hickman,

We are writing to share the comments of the Treaty Policy Working Group 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), released on 19 December 2014.

The Treaty Policy Working Group (TPWG) is an informal association of large global companies based throughout the world that represent a broad spectrum of industry sectors. The TPWG has been working since 2005 with the OECD, and more recently with the UN, to analyze and provide constructive comments on tax policy and administration concerns regarding transfer pricing, permanent establishment (PE), profit attribution, and related issues that are critical to our ability to avoid double taxation and conduct international trade and investment. The TPWG has also participated in consultations regarding most if not all OECD discussion drafts on transfer pricing issues over the past decade, and also provides input on UN transfer pricing work.

The TPWG appreciates the opportunity to comment on this Discussion Draft, which raises a number of issues important to our member companies.

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1 The membership of the Treaty Policy Working Group is currently comprised of the following companies: Amazon.com, Inc.; BP plc; Cisco Systems, Inc.; Procter & Gamble Co.; Salesforce.com Inc.; TD Bank Group; Thomson Reuters Corporation; Tupperware Brands Corporation; and Vodafone Group plc.

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I. Executive Summary

The Discussion Draft on BEPS Actions 8, 9, and 10 represents a substantial change to Chapter I and to transfer pricing guidance via the possible introduction of special measures. Overall, the TPWG member companies are concerned that much of the new language (not least of which being the special measures) appears to be motivated by a desire to achieve a specific result. Not only does the TPWG believe that the Discussion Draft Chapter I guidance diverges from the arm’s length principle in numerous ways, but we also remain concerned that the practical outcome of adopting the Chapter I language would be to create substantial uncertainty regarding nearly all transfer pricing exercises, including those addressing routine transactions and where no motivation for BEPS exists. In short, we believe that the new Chapter I language in the Discussion Draft is too sweeping in its coverage. It appears that WP6 is attempting to address what is likely a limited set of circumstances by rewriting all the general guidance on transfer pricing, and in so doing, is diverging from the fundamental arm’s length principle.

The existing guidance embodied in the OECD Transfer Pricing Guidelines strikes an appropriate balance between thoroughness and practicality, and acknowledges that a transfer pricing exercise is not an exact science. The changes proposed by the Discussion Draft negate this approach, and instead direct that the transfer pricing exercise should be one of extreme detail and precision. Not only would the approaches advocated in the Discussion Draft be exceedingly burdensome for taxpayers and tax authorities, but we are concerned that their application would frustrate even ordinary, routine transfer pricing analyses, force the use of profit splits for many more transactions, and expand the circumstances in which the transaction may be disregarded or recharacterized.

The Discussion Draft contains many statements regarding how it believes unrelated parties to a transaction divide and govern their functions, assets and risks, and how, in contrast, it believes related parties conduct themselves. The text reveals what the TPWG believes is an inaccurate understanding and appreciation of how many businesses operate in the global economy. Consequently, WP6 draws what we believe are incorrect conclusions about arm’s length behavior, which are then used to make inaccurate inferences about, and impose unrealistic and unnecessary burdens on, related-party transactions. TPWG members believe that the provisions of Chapter IX of the Guidelines, which were just adopted in 2010, strike a more careful and appropriate balance on the issues of control and risk than the proposed language in the Discussion Draft intended for Chapter I.

The approach of the Discussion Draft to the recharacterization and non-recognition of transactions is dramatically different from that of the existing Guidelines. We believe that the very subjective principles in the Discussion Draft that would govern when non-recognition or
recharacterization may be imposed would add to the number and magnitude of controversies and substantially increase the risk of double taxation.

We note that the introduction of “special measures” is unprecedented in OECD transfer pricing practice, and therefore deserves careful thought as to their design and implementation. Any prescriptive special measure which replaces a taxpayer-specific factual analysis with a mandated result departs from the theoretical foundation of arm’s length transfer pricing policy. We believe that a special measure should be considered only as an approach of last resort, to be used only in those narrow circumstances where the other numerous and substantial proposed revisions to the Guidelines prove insufficient. As this project moves towards articulating specific “special measures,” we believe that the question of whether a special measure is within or beyond the arm’s length principle can no longer be avoided. The distinction between a special measure which is within the arm’s length principle and one that is beyond it is an important one, and it should be made clear whether an option indeed is or is not intended to be within the arm’s length principle. The difference could affect how the rule is designed, how it is interpreted, and how it is implemented as a matter of national law. Whether a special measure is intended to be within the arm’s length principle or not also will affect judicial review of the application of the special measure, as the legal foundation of the rule will be different in the two cases.

Whether it is appropriate to introduce any special measure depends on the assessment of whether the other BEPS Actions are sufficient to achieve the goal of assuring that transfer pricing outcomes are in line with value creation. The ongoing work on intangibles, risk and recharacterization, and profit splits represents a very significant effort to elaborate, and indeed change, existing transfer pricing guidance. It cannot be known whether there is a need for special measures until the effects of that considerable body of work are seen in practice.

We believe that there is no prudent way to approach the question of whether special measures are needed without taking the time to assess whether the rest of the BEPS Action Plan will have its desired result. We recommend that WP6 be given a mandate to review at an appropriate point the implementation of the many changes to the Guidelines arising from the work on intangibles, risk and recharacterization, and profit splits, in addition to changes which will arise from other elements of the BEPS Action Plan such as preventing the artificial avoidance of PE status, preventing treaty abuse, strengthening CFC rules, and country-by-country reporting, and report at that time whether special measures are, in fact, warranted. Based on this assessment, then WP6 can reengage on special measures at such point as it is clear that special measures will be needed to achieve the results agreed upon in the BEPS project, despite the implementation of the rest of the BEPS project.

Our detailed comments first offer some perspectives on the new and modified language in the Discussion Draft addressing risk and recharacterization. Second, we provide our comments regarding the special measures discussion.
II. TPWG Comments on Risk and Recharacterization

Working Party 6 has made substantial proposed additions and modifications to Chapter I of the OECD Transfer Pricing Guidelines, and the TPWG appreciates the opportunity to provide business input into this process.

A. Contractually-Provided Functions, Assets, Risk vs. Actual Conduct

The Discussion Draft states in numerous places that contractual provisions may not be relied on to identify (“delineate”) the transaction or define the functions, assets, and risks assumed by the related parties involved in a transaction. Instead, the Discussion Draft directs that the actual conduct of the parties must be considered, and that actual conduct trumps contractual provisions if the two are inconsistent with each other. The TPWG is puzzled by the repeated emphasis of this point, particularly because the existing Guidelines do not advocate or even reference the use of intercompany contracts as the sole or primary basis for functional analysis. The existing Guidelines indicate that the analysis of contractual terms “should be a part of the functional analysis.” The existing Guidelines go on to provide that the actual conduct of the parties should be examined. Further, the existing Guidelines provide that where economic substance differs from form, the economic substance should be respected rather than the form. If WP6 is trying to address situations in which a taxpayer or tax authority has skimped on the functional analysis by relying solely on the contractual terms between the related parties, the existing Guidelines already provide guidance suggesting that this may not be sufficient. Addressing these situations is the role of transfer pricing risk assessments and audits, and no new guidance is required.

For this reason, we find it troubling that the proposed language appears to go so much further to direct taxpayers and tax authorities to scrutinize every nuance of the intercompany relationship. Because the new language in the proposed guidance is not needed to ensure that both contractual and factual circumstances are considered, we are concerned that the proposed language will be used to serve other purposes: namely, to frustrate even ordinary, routine transfer pricing analyses; to force the use of profit splits for many more transactions; and to expand the circumstances in which the transaction may be disregarded or recharacterized.

We also note a potential inconsistency in the Discussion Draft’s view of the importance of contracts versus actual behavior of the parties. The Discussion Draft seems to presume that the “divergence of interests” between unrelated parties will result in the parties negotiating and delineating contract terms that fully, accurately and precisely define their relationship, thus suggesting that the arm’s length contract reigns supreme. This impression is created because the

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2 See, e.g., TPG, paras. 2, 3, 4, 5, 6, 7, 43, 44, 60.
3 TPG, para. 1.52.
4 TPG, para. 1.53.
5 TPG, para. 1.65.
Discussion Draft then goes on to say that related parties may not have the same divergence of interests, and for this reason, it is essential to look beyond the related-party contract and consider the behavior of the related parties. The TPWG submits that unrelated parties also do not conclude contracts that define and govern every aspect of their relationship, and that arm’s length operational behavior often extends beyond what is defined in a contract. Thus, the TPWG believes that contracts and behavior are relevant in understanding both related-party and unrelated-party transactions.

We agree that it is important that all the relevant intercompany transactions be identified for purposes of establishing arm’s length pricing and that the behavior of the parties may reveal such transactions. However, we suggest that the example in paragraph 8 of the Discussion Draft is not as clear as it could be – are the services provided to the subsidiaries for the benefit of the subsidiaries, or for the benefit of the parent? Instead, we suggest that the example in paragraph 6, which the Discussion Draft uses to illustrate a recharacterization of a license into a service, might be a better example of a failure to identify a transaction. Rather than reach the conclusion that the transaction was not a license, a less controversial solution would be to determine that the licensor, Company P, may have performed valuable services separate from the license to Company S, and Company P may require compensation for these services.

**B. “Extreme” Functional Analysis: “Delineating the Transaction”**

The proposed changes are intended to modify the basic guidance in Chapter I of the Guidelines that is generally applicable to all types of intercompany transactions. Because most intercompany transactions are routine or relatively routine in nature, and often are undertaken between two high-tax jurisdictions, we must ask whether the proposed language really is intended to be generally applicable, and, if so, whether it would provide appropriate transfer pricing guidance for essentially all intercompany transactions, particularly the most common, routine transactions. On balance, we are concerned that the language ill-serves the needs of most transfer pricing exercises, and will raise the bar to a point at which even the most routine transactions could be argued to have nuances that require departures from existing transfer pricing guidance. We fear that the concerns over BEPS have infused the Discussion Draft to a point at which even routine transactions well-suited to the application of one-sided methods such as the TNMM are suspected to be sources of base erosion and profit shifting. If adopted in their current form, we believe that the Discussion Draft’s proposals would make the application of transfer pricing rules so complex and nuanced, even for routine transactions, that taxpayers and tax authorities would have no reasonable certainty or common ground.

The proposed guidance regarding delineation of the transaction reads as an almost theoretical exercise that is supposed to be conducted with an extreme degree of specificity. The TPWG

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6 TPG, para. 1.53.
believes that the language lacks practical relevance and cannot be reasonably applied either by taxpayers for all the transactions they must price and document or by tax authorities to all the transactions they must review and audit. Moreover, the proposed guidance directs that the process of defining and delineating the controlled transaction should be isolated from the process of identifying comparable, arm’s length transactions. Yet, understanding how unrelated parties tend to transact is an essential point of reference for understanding the related-party transaction and determining whether there is anything significantly unique about the related-party transaction vis-à-vis the typical market transaction. Conducting a functional analysis and delineating a transaction are not separate exercises; rather, they are interrelated. The sole purpose of the functional analysis is to establish an arm’s length price, usually by reference to market comparables; therefore, we believe it is central to the functional analysis to view it as linked to the comparables and pricing analysis, rather than “distinct.”

A prominent example is in paragraph 4, which questions the contractual terms between Companies P and S, under which S acts as a distributor for P’s branded products in its local market. The example goes on to say that the contract does not specify the nature or extent of the marketing and advertising to be done by S, and the analysis of the behavior of the parties reveals S performs extensive advertising and marketing. The example adds that it is then necessary to “identify further how the parties determine the nature and scale of the brand-building activities, and how the activities are conducted and risks managed.” What is not stated here is what is typical in the industry. The implication in the example is that what S is doing is somehow unusual and that every detail must be developed. Yet, if it is common in the industry for distributors to undertake substantial advertising and marketing, the important facts to develop relate to whether S’s effort is substantially comparable to the efforts of independent distributors that could be used as comparables.

Likewise, in the example in paragraph 6, in which the conclusion is that the transaction does not “seem” like a license, and instead should be recharacterized as a service, the TPWG submits that market context could be instructive in understanding the transaction. If the potential comparable transactions include assistance from the licensor, then there certainly should be no basis to recharacterize the transaction.

In sum, the TPWG believes that the Discussion Draft guidance on delineating the transaction lacks context, and would be substantially improved if the linkage between functional analysis and comparable transactions were recognized.

The most commonly used transfer pricing method is the Transactional Net Margin Method (TNMM), in large part because it is a method that is practical to apply, particularly to the many

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7 Discussion Draft, para. 1.
8 Discussion Draft, para. 4.
routine transactions so common within MNE groups. Given the many transactions MNE groups have and the many jurisdictions in which they must operate and prepare documentation, this is a practical adaptation to the complexities of international tax regimes. However, the sweeping applicability of the proposed language could be read to require every one of these transactions and relationships to be revisited and scrutinized in great detail. Equally important, because the taxpayer has the ability to develop so much more “information” about its own operations (given enough time and effort), but has no ability to obtain similar details about the operations of the independent companies it has used as TNMM comparables, we believe a very likely outcome of applying the proposed guidance as written will be that tax authorities will attempt to disqualify the TNMM as the “best method,” due to perceived “lack of comparability” between the independent companies and the tested party. Moreover, we believe this problem will arise not only when taxpayers seek to use TNMM, but also when tax authorities seek to use it, as well.

If WP6 does not believe that the TNMM is “broken” for routine transactions, then we respectfully suggest that it should not try to “fix” it. In our view, the use of the TNMM is rarely, if ever, an example of BEPS. In fact, we believe that the use of TNMM, in many cases, over-renumerates routine tested parties. This is because the independent companies that are used as the TNMM comparables in nearly all cases have a wider range of functions and risks than a routine tested party within an MNE group. Consequently, we do not believe that the use of the TNMM for routine operations is an underlying cause of BEPS, and its selection and application as the most appropriate method should not be modified by the BEPS project. The same holds for other methods, such as the comparable uncontrolled price (CUP) method, that rely on comparables.

C. Risk, Fragmentation, and Interdependency

The Discussion Draft contains many statements regarding how it believes unrelated parties to a transaction divide and govern their functions, assets and risks, and how, in contrast, it believes related parties conduct themselves. The text reveals what the TPWG believes is an inaccurate understanding and appreciation of how many businesses operate in the global economy. Consequently, WP6 draws what we believe are incorrect conclusions about arm’s length behavior, which are then used to make inaccurate inferences about, and impose unrealistic and unnecessary burdens on, related-party transactions.

In the substantially new discussion on risk in section D.2, the theme regarding the asserted “divergence of interests” between independent parties is reiterated. The Discussion Draft notes that between unrelated parties, various terms, conditions, and safeguards are implemented so that the actions of one party to the transaction do not adversely affect the other party. The Discussion Draft goes on to say that because unrelated parties have adverse interests, “it generally makes

9 Discussion Draft, para. 38.
“sense” that each party would only accept those risks over which it felt it had sufficient control to manage the outcomes. 10 From this, the further conclusion is drawn that, if this is how unrelated parties operate, then so, too, should a given related party be assumed to take on only those risks it can manage itself. Asserting this as the “arm’s length” paradigm thus has implications for the evaluation of related-party behavior. In essence, the Discussion Draft maintains that if a related party cannot demonstrate that it manages or controls a certain risk, then it may not be respected as assuming that risk, regardless of the contractual or financial arrangements between the related parties. 11

The Discussion Draft acknowledges that there is a debate over this and requests comments. In our view, the Discussion Draft makes too much of the notion of adversity of interests between unrelated parties, and over-interprets the relevance of moral hazard. It is the direct experience of TPWG members that, contrary to the Discussion Draft’s assertion, arm’s length business relationships cannot be characterized by a pure “adversity of interests.” Instead, unrelated parties with an on-going business relationship have a substantial commonality of interests very similar to what exists between related parties. Consequently, there is an interrelationship of functions related to risk management among unrelated parties in these relationships. Thus, we believe that the “arm’s length paradigm” asserted by WP6 is not an accurate characterization of arm’s length business dealings. In our direct experience, arm’s length business dealings are far more interrelated and complex than the Draft allows. As a result, we believe the Discussion Draft too readily asserts that “it generally makes sense” that each party would only accept those risks over which felt it had sufficient control to manage the outcomes. This suggests risks can be easily compartmentalized and discretely “managed.” Instead, it is the experience of the TPWG member companies that many kinds of risks are not readily susceptible to management, that even where some types of management are possible, management may not be performed only by one party, and that the outcomes of risk and risk management are often not limited to just one party in an arm’s length relationship.

Take, for example, an automobile company. In the production of its vehicles, it relies heavily on unrelated parties to design and manufacture parts and subsystems. This is standard in the industry. For any given vehicle program, suppliers for various subsystems must be qualified and selected. The relationship with the supplier will last at least as long as the vehicle program is in production, and in a larger sense, as long as those vehicles remain on the road, since the supplier will produce replacement parts for these vehicles long after those models are no longer sold new. Thus, the relationship can last for 10 to 20 years. In a very narrow sense, the auto company and the supplier have opposing interests: the short-term profit motive of each in the negotiation of the pricing of the subsystems. However, a broader, longer-term mutual interest is an essential

10 Id.
11 Discussion Draft, paras. 61, 63.
part of their relationship. Namely, if the auto company forces too low a price for the subsystem, will the supplier try to reduce its costs by skimping on quality control, investing in maintaining its plant and equipment, and other factors that could affect quality, reliability, and timely delivery? Thus, the auto company has an interest in the financial health and viability of the supplier. Conversely, if the supplier insists on too high a price for the subsystem, will the auto company’s profit margin on the vehicle be eroded to the point at which the auto company will terminate the program, seek another supplier, or fail to invite the supplier to bid on another vehicle program? These factors suggest the supplier has an interest in the longer term viability of the program and its relationship with the auto company. We further note that many of the features of arm’s length business contracts focus on creating incentives to align interests between unrelated parties.

The Discussion Draft tries to use the notion of “adversity of interests” and “moral hazard” to draw very bright lines between unrelated parties, and then contrast that with related parties, which it asserts have a commonality of interests by virtue of common ownership. It then goes on to suggest that these differences should influence transfer prices, and perhaps even the choice of transfer pricing method, tilting the field toward the profit split among related parties. Yet, as we have indicated, many unrelated parties also have a strong commonality of interests, and do not necessarily enter into “profit splits” as their pricing mechanism. Rather, they usually have buy-sell transactions, license transactions with royalties, and payments for services based on quoted fees. It is fair to say that, notwithstanding their interdependencies, unrelated parties rarely “split profits” as their method of remunerating each other.

The Discussion Draft asserts that unrelated parties only assume risks that they can manage. Yet examples abound that suggest otherwise. Following our automotive example, a production problem at the subsystem supplier may halt production at the auto manufacturer because the level of reliance the manufacturer has on the subsystem supplier is very high, by virtue of just-in-time inventory management and logistics. The manufacturer does not have much control over this situation (beyond holding excess inventory of components), and yet is affected by this risk. Another example is companies’ increased reliance on software systems to handle various functions – ordering, logistics, production management. A problem in one of these software systems may take down an entire operation, and thereby affect upstream and downstream operations. Yet the software license with the unrelated software vendor will not contain indemnities that compensate for shut-downs, lost productivity, and the like. In fact, any business transaction involves the risk that either of the parties may not perform as anticipated by the other party, but indemnities and warranties do not cover the full costs and consequences of all these risks. In fact, the way unrelated businesses transacting with one another often deal with risks that could have spill-over effects between them is to collaborate even more closely, sharing information, jointly trouble-shooting, and becoming more operationally integrated.
An adversity of interests is not as essential a characteristic of arm’s length dealings as the Discussion Draft asserts. We believe an adversity of interests should not be held up as the arm’s length paradigm, nor should adverse interests be fabricated between members of the MNE group in an attempt to mimic “arm’s length” behavior.

Likewise, we do not believe moral hazard exists in a related-party context to the extent suggested by the Discussion Draft. Moral hazard exists when one party that has more information about the likelihood of a risk, and may be able to influence that likelihood, enters into a transaction in which the costs associated with the negative outcomes of the risk are borne by a completely different party. This is not a fact pattern that fits an MNE group. If one affiliate undertakes a risk that creates costs, those costs are borne within the MNE group. They are not laid off to an unrelated party. All members of the MNE group report to the same group of shareholders. Consequently, we believe that the concept of moral hazard is not an appropriate touchstone for the Guidelines.

TPWG members believe that the provisions of Chapter IX of the Guidelines, which were just adopted in 2010, strike a more careful and appropriate balance on the issues of control and risk than the proposed language in the Discussion Draft intended for Chapter I. We would recommend that WP6 reconsider the language in Chapter IX and ensure that modifications to other parts of the Guidelines are consistent with Chapter IX.

D. Reasonableness and Reliability

The existing Guidelines provide that a transfer pricing exercise must be bounded by reasonableness and reliability. They do not seek perfection. For example, Chapter I provides:

- “It is important to put the issue of comparability into perspective in order to emphasise the need for an approach that is balanced in terms of, on the one hand, its reliability and, on the other, the burden it creates for taxpayers and tax administrations.”\(^{12}\)

- “It is important not to lose sight of the objective to find a reasonable estimate of an arm’s length outcome based on reliable information. It should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer.”\(^{13}\)

TPWG members are concerned that the Discussion Draft emphasizes precision without an appropriate balancing consideration of either what is reasonable or what improves the reliability of the transfer pricing exercise. Specifically, the new language in the Discussion Draft adds new

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\(^{12}\) TPG, para. 1.7.

\(^{13}\) TPG, para. 1.3.
references to accuracy in at least 13 paragraphs\textsuperscript{14} and precision in at least two\textsuperscript{15}, nowhere modified with the concept of reasonableness. The new Discussion Draft language only mentions reliability twice.\textsuperscript{16} By contrast, Chapter I Section D of the existing Guidelines rarely invokes the notion of accuracy and never precision, and when it does, it is commonly modified as “reasonably accurate” or “sufficiently accurate.” We believe the existing Guidelines present more balanced and pragmatic guidance.

The Discussion Draft is considerably more demanding than the existing Guidelines in the factual development it requires with respect to the controlled transaction, yet the fundamental requirement of taxpayers and tax authorities remains the same: “to find a reasonable estimate of an arm’s length outcome based on reliable information.”\textsuperscript{17} As we have expressed above, TPWG members are concerned that the collection of ever more detailed information will not serve the purpose of developing reasonable and reliable transfer prices. At the same time, the information available to taxpayers about the arm’s length transactions used as potential comparables will not increase. “Delineating the transaction” as contemplated by the Discussion Draft would impose significant additional burdens on taxpayers to create more “information” that may be irrelevant. The TPWG is concerned that this detailed information gathering in service of “delineating the transaction” will not add to the reliability of most transfer pricing analyses, particularly those that relate to the most common, routine transactions. Worse, we are concerned that such “information” may be used to undermine the identification and use of reasonably reliable comparables, on the basis that the arm’s length evidence is not shown to be fully comparable along every dimension with the related party transaction.

**E. Recharacterization**

The approach of the Discussion Draft to the recharacterization and non-recognition of transactions is dramatically different from that of the existing Guidelines. The existing Guidelines provide that recharacterization should be avoided, because substituting alternative transactions for legitimate business transactions is “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.”\textsuperscript{18} They, therefore, stipulate that recharacterization should be limited to two situations:

1) Where economic substance differs from form, the economic substance should be respected (rather than the form); or

\textsuperscript{14} Discussion Draft, paras. 1, 5, 9, 11, 36, 43, 78, 80, 81, 82, 83, 84, 89.
\textsuperscript{15} Discussion Draft, paras. 2, 73.
\textsuperscript{16} Discussion Draft, paras. 76, 77.
\textsuperscript{17} TPG, para. 1.13.
\textsuperscript{18} TPG, para. 1.64.
2) Form and substance match, but the transaction, viewed in its totality, differs from commercially rational transactions between unrelated parties AND the actual structure of the transaction practically impedes the determination of an arm’s-length price.  

However, the Discussion Draft upends this test. Instead of having a two-pronged test as the second element, the Discussion Draft suggests that the test really should be whether any effort should be made to find a price for a transaction if it “lacks the fundamental economic attributes of arrangements between unrelated parties.” The Discussion Draft goes on to clarify that the test to be applied is whether the parties are behaving in a “commercially rational” manner by entering into the transaction. “Commercial rationality” is further defined as existing when each of the parties has a reasonable expectation that the transaction will enhance or protect its commercial position in comparison to other realistically available opportunities (including the alternative of not entering into the transaction). The Discussion Draft further provides that if the taxpayer’s transaction is not recognized, then the transaction that would replace it should be based on an alternative transaction that does permit the parties to better their commercial or financial positions. Overall, the Discussion Draft eliminates a narrow exception in favor of a much broader exception. In so doing, the exception swallows the rule and creates a wide berth for non-recognition and recharacterization. The Discussion Draft appears to prefer imposing hypothetical alternative transactions (that tax authorities can assert evidence greater “commercial rationality”) over determining the arm’s length pricing of the transactions that actually occur.

The Discussion Draft suggests that an extremely subjective standard may be applied in judging whether a transaction will be respected as characterized by the taxpayer. For example, paragraph 6 concludes that “Company S does not seem to be operating as a licensee” (emphasis added). Other passages in the Discussion Draft signal a broad desire to recharacterize, rather than to do the work of pricing the transaction that did occur.

This portion of the Discussion Draft is very troubling, in that it is unclear what other hypothetical transactions a tax authority might assert in place of the actual transaction. How can taxpayers comply with high and rising documentation requirements if, according to any given tax authority, it should have documented a different transaction? In jurisdictions with documentation-related penalties, how can taxpayers reasonably comply and protect themselves if there is no effective constraint on recharacterization or non-recognition by a tax authority? If the tax authority is the party allowed to select the hypothetical alternative, may it pick the alternative that yields the most tax revenue, and is there no constraint or incentive for the tax authority to respect the taxpayer’s characterization of the transaction? Further, if hypothetical transactions are widely allowed, how can taxpayers be assured that all affected tax authorities will agree on the same hypothetical? Yet this is what is required to ensure double taxation is relieved.

19 TPG, paras. 1.64, 1.65.
Moreover, the stated requirement for a transaction to be recognized is that both parties had to believe *ex ante* that the transaction enhanced their position. But tax authorities will be reviewing transactions after the fact; if this criterion is applied in hindsight, non-mutually enhancing results may arise. That is, with hindsight, many third party deals might not have been done at all, or would not have been done at the agreed prices and terms. But unrelated parties do not get a “do-over.” They have to live with the outcome of their prior decisions. If tax authorities use hindsight and conclude that they do not see how both related parties, in fact, benefited, and then use this rationale to disallow or recharacterize the transaction, they could well reach a non-arm’s length result.

We also observe a troubling link between the Discussion Draft’s view that an adversity of interests paradigm must be imposed on related parties and the expansion of non-recognition/recharacterization. Specifically, in the example in paragraphs 90-91, the principal reason why the transaction is not recognized relies on the assumption that S1 and S2 have no commonality of interests to exploit the trademark in a mutually advantageous way, but instead, have adverse interests. If exploitation of the trademark is, indeed, best served through S1’s sales of trademarked products, there is no reason why S1 and S2 cannot successfully collaborate to achieve this together, as independent licensors and licensees normally do. Thus, TPWG members disagree with the analysis and conclusion in this example. We further note that the example completely ignores the fact that if S2 paid an *arm’s length* price of $400 million for the trademark, S1 now has new financial resources it can use to pursue new ventures and opportunities to increase its profits.

We appreciate that the Discussion Draft has included language to affirm that the “mere fact” that the same kind of transaction may not be observed to take place between unrelated parties “does not mean that it should not be recognized.” However, the very subjective principles in the Discussion Draft that would govern when non-recognition or recharacterization may be imposed belies this statement and would add to the number and magnitude of controversies and substantially increase the risk of double taxation.

III. TPWG Comments on Special Measures

A. General Comments

We welcome the opportunity to provide our comments on potential special measures. The introduction of “special measures” is unprecedented in OECD transfer pricing practice, and therefore deserves careful thought as to their design and implementation.

We believe that a special measure should be considered only as an approach of last resort, to be used only in those narrow circumstances where the other numerous and substantial proposed
revisions to the Guidelines are not capable of creating an alignment between where profits are reported and where value is created. The Discussion Draft identifies the residual risks that may remain after application of the revised Guidelines expected to result from other BEPS work as relating to (i) information asymmetries, and (ii) the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities. We assume that all of the five proposed options are intended to relate to one or other of those two residual risks. As discussed below, some are more closely connected to the identified residual risks than others.

Introducing “special measures” as a means to determine transfer prices needs to proceed with extreme caution. The introduction of a prescriptive rule to determine a result is in its nature contrary to the theoretical foundation of the arm’s length principle. The essential proposition of the arm’s length principle is an intensely factual exercise. The functions, assets and risks of a taxpayer are determined, and the best possible match is sought in the world of unrelated party transactions to assess how well the taxpayer had established a price that could have been agreed between similarly situated unrelated parties. Any prescriptive special measure which replaces a taxpayer-specific factual analysis with a mandated result departs from the theoretical foundation of arm’s length transfer pricing policy. For that reason, a special measure should be contemplated only if the specified residual BEPS risk cannot be addressed in the normal case through the application of the revised guidance which will emerge from the entirety of the BEPS project.

As this project moves towards articulating specific “special measures,” we believe that the question of whether a special measure is within or beyond the arm’s length principle can no longer be avoided. The Discussion Draft states: “Some of these measures could be seen as within the arm’s length principle and others beyond. 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.”

We respectfully disagree. The distinction between a special measure which is within the arm’s length principle and one that is beyond it is an important one, and participating country delegates should be clear whether an option indeed is or is not intended to be within the arm’s length principle. The difference could affect how the rule is designed, how it is interpreted, and how it is implemented as a matter of national law. Whether a special measure is intended to be within the arm’s length principle or not also will affect judicial review of the application of the special measure, as the legal foundation of the rule will be different in the two cases.

We understand that the concept of a special measure which is to apply “within” the arm’s length principle is one which can be seen as replicating, to a reasonable extent, the analysis that would otherwise take place under the Guidelines, but perhaps has been impeded in the past due to information asymmetries or the ability of taxpayers to allocate capital to lowly taxed minimal functional entities. In one sense, this use of a special measure is more dangerous to the integrity
of the arm’s length principle than a special measure expressly designed to be outside the arm’s length principle, as it constitutes an assertion that the Guidelines are unequipped to deal with a set of commercial transactions. The inherent risk in asserting such a possibility is that it would seem to endorse the possibility that tax administrations could assert in cases other than the specified options that a transaction or arrangement could be addressed through a new and different special measure. Granting implicit license to tax administrations around the world to create new special measures creates unacceptable risk to the fundamental role of the Guidelines to create consistent application of the arm’s length principle. It will be essential that final guidance makes it clear that the particular special measures which may be agreed as part of the BEPS process are the only special measures which could be applied by a tax administration.

If a special measure is intended to operate outside the arm’s length principle, then it would seem to be a rule which creates a mandated result regardless of the normal application of the Guidelines. Conceptually, this approach emphasizes certainty and administrability over theoretical purity.

If a special measure indeed operates outside the arm’s length principle, then presumably it could not be applied by tax administrations as a mere interpretation of existing national legislation and treaty provisions which require intercompany dealings to be priced according to arm’s length principles. Absent both implementing domestic legislation and treaty amendments, it is hard to see how introducing the special measure into the Guidelines or even incorporating the rule into a treaty amendment could authorize taxation on that basis, as the treaty merely would then permit something that national law had not been amended to authorize.

If the special measure is intended to be within the arm’s length principle, then there must be priority given to efforts to establish the proper price under normal arm’s length principle standards without recourse to the special measure. Taxpayers should have the opportunity to show why their results are consistent with the arm’s length principle without the application of the special measure. In this case, there would be a clear priority of application, in that the special measure could be applied only after some demonstrated failure of the taxpayer to show that an arm’s length result could be achieved under the normal application of the Guidelines.

As an example, the “income method” as introduced in the U.S. transfer pricing regulations may be regarded as a special measure which is intended to operate within the arm’s length standard. That method results in a prescriptive outcome, much as the proposed options seem to contemplate. Yet it is clear that the “income method” can be applied only if it is established that it indeed is the “best method” in light of the facts and circumstances of the case, including the appropriate comparability analysis. Any of the proposed special measures which is intended to

21 Treas. reg. section 1.482-7(g)(4).
operate within the arm’s length principle should similarly be subject to the requirement that it be shown to be the most appropriate method in the circumstances.

If the special measure is meant to be within the arm’s length principle, then it should be applied only if its result is demonstrably superior to the intercompany pricing as proposed by the taxpayer. There should be a somewhat higher burden on the tax administration to apply a special measure than to assert the application of one of the stated methods, due to the prescriptive nature of the rule and the possibly significant consequences. One can anticipate taxpayer challenges in court to the application of the special measure either as a whole or as applied to the taxpayer, if its terms create outcomes which are outside a reasonable range of arm’s length results.

The application of a special measure should not affect the availability of double tax relief and MAP consideration, including any applicable arbitration provisions. In every case, the special measure is intended to set a price between associated enterprises. There is no reason to exclude such determinations from MAP or any other available double taxation relief or other dispute resolution mechanisms. If an additional deterrent or punitive element is desired, that should be through the application of penalties as called for by law, not by the removal of double tax relief or other dispute resolution protection. Assurance of relief from double taxation and efficient resolution of disputes is essential to supporting cross-border trade and investment.

If the special measure is intended to operate beyond the arm’s length principle, there is a particular need to confirm that the application of the special measure is eligible for relief from double taxation and MAP consideration, including any applicable arbitration provisions. Articles 9(1) and 9(2) should be revised to authorize the special measure and to require corresponding adjustments.

In all cases, since a special measure is intended to apply only in a small minority of cases and the consequences of its application can be severe, both the trigger and the consequences must be expressed with precision.

In any event, whether it is appropriate to introduce any special measure depends on the assessment of whether the other BEPS Actions are sufficient to achieve the goal of assuring that transfer pricing outcomes are in line with value creation. The ongoing work on intangibles, risk and recharacterization, and profit splits represents a very significant effort to elaborate, and indeed change, existing transfer pricing guidance. It cannot be known whether there is a need for special measures either “within” or “beyond” the arm’s length principle until the effects of that considerable body of work are seen in practice. We recommend that WP6 be given a mandate to review at an appropriate point the implementation of the many changes to the Guidelines arising from the work on intangibles, risk and recharacterization, and profit splits, in addition to changes which will arise from other elements of the BEPS Action Plan such as preventing the artificial
avoidance of PE status, preventing treaty abuse, strengthening CFC rules, and country-by-
country reporting, and report at that time whether special measures are, in fact, warranted.

B. Comments on Specific Options

1. Option 1: Hard-to-value intangibles

Of the five Options, this is the only one which could be regarded as potentially within the arm’s
length principle. As written, this Option would apply only if the taxpayer failed to produce
documentation of the projections on which it made its initial pricing determination. We agree
with the proposal that the taxpayer must have the opportunity to rebut the presumption by
demonstrating the robustness of its \textit{ex ante} projections.

This Option would allow the tax administration to consider actual results in years subsequent to
the transaction to adjust the original price as determined by the taxpayer. Strictly speaking, it is
hard to justify that element of the Option as within the arm’s length principle, as third parties at
arm's length never have knowledge of future information to set prices for a transaction.

If this Option is to be further developed, we suggest that the Option include the following
elements:

The design of this Option as essentially a sanction for the failure to comply with documentation
requirements should not change. It should be clear that the special measure has no application to
a taxpayer which reasonably complies with requirements to contemporaneously document the
projections on which it relies, and to disclose those projections to the relevant tax
administrations.

The Option should make it clear that any adjustments made pursuant to an imputed contingent
payment mechanism must be subject to the arm’s length principle and the Guidelines. For
example, the Option should make it clear that no price adjustment could be made for
extraordinary events that were beyond the control of the controlled taxpayers and that could not
have reasonably have been anticipated at the time the controlled agreement was entered into.

This special measure will have the intended effect of reducing the impact of, and disputes arising
from, information asymmetry between taxpayers and tax administrations.

2. Option 2: Inappropriate returns for providing capital - Independent
investor

Option 2 clearly would operate outside the arm’s length principle, as it disregards completely the
ownership of productive assets.
This special measure relies on a very dubious assertion that the more rational investment opportunity normally is in an entity without access to a productive asset. Between the two investment opportunities, an investment in an entity which uses the capital to acquire a long-lived productive asset would seem to be a very rational decision. Indeed, of the two entities, only the entity owning the asset will enjoy the lasting value arising from property ownership.

Presumably, the issue which the special measure seeks to address is the division of returns between the owner of the asset and the other entities which contribute to the generation of returns from the asset. As this allocation of returns is being reassessed in, *inter alia*, the risk and recharacterization, profit split and intangibles work, adoption of this special measure would seem not to be appropriate until such time as the effect of that other work can be assessed. In any event, there would seem to be no policy foundation for a special measure which denies all return to a productive asset. This Option conflicts with accepted transfer pricing policy by completely disregarding the valuable economic contribution of property ownership.

The effect of this special measure on taxpayer behavior cannot be assessed until there is greater clarity as to the circumstances under which it could apply.

3. **Option 3: Inappropriate returns for providing capital - Thick capitalization**

This special measure is less inappropriate than Option 2, as it does not completely ignore the right of a capital owner to allocate its assets as it considers appropriate, or that some return should be attributed to a productive asset. This Option still deviates from the arm’s length principle, however, as there is seldom a case in normal commercial transactions when a capital provider which is choosing whether to finance an acquisition through capital or debt is under third party commercial constraints to limit the amount of its capital deployed.

It is not apparent what problem this special measure is trying to address. If the policy goal here is that excess capital contributed to a subsidiary attracts a return the nature of which should be taxed in the parent entity, then this is a CFC issue.

If this Option is intended to reduce the incentive to allocate inappropriately high returns to assets, then that policy goal is more properly handled under the expansive work on risk and recharacterization, profit splits, and intangibles.

Since over time, returns to equity exceed returns to debt, it is normal economic behavior for investors to favor equity. Setting a “predetermined capital ratio” that skews investments away from equity will thus distort normal economic decisions. Presumably the application trigger for this special measure would need to be coupled with something more than just “thick capitalization,” as the problem it is trying to solve is not apparent otherwise.
The effect of this special measure on taxpayer behavior cannot be known until there is more detail as to the nature of the predetermined capital ratio.

4. **Option 4: Minimal functional entity**

This Option describes a set of facts which is directly addressed by the ongoing work of revising the Guidelines in areas including risk and recharacterization, profit splits, and intangibles. All of that work is relevant to the scenario described in this Option. Therefore, in this case even more than any of the other Options, it would be premature to adopt such a special measure until the results of the other Guidelines changes have been tested in practice.

This Option is justified in the Discussion Draft on the basis that it might be “simpler and more effective” for a tax administration to apply the special measure than to apply the Guidelines, as modified through the BEPS project. We believe that the desire for simplicity is inadequate justification for departing from applying the arm’s length principle under the facts and circumstances of the case. The modified Guidelines guidance arising from the BEPS project, plus the enhanced reporting obligations arising from other BEPS Actions, will provide tax administrations with many other tools with which to apply the arm’s length principle without the need for special measures.

The Discussion Draft proposes several different consequences under this Option. The proposed consequences differ in the appropriateness of their results.

Whether the mandatory profit split approach can be seen as achieving an administrable result within the arm’s length principle will depend on the identification of the profit to be split and of the allocation factors and how they may be applied to split the relevant profits. The work at this stage, of course, has not yet begun to address those questions. The further work will need to acknowledge the valuable economic contributions of the ownership of property, including intangible property. A reallocation based on pre-determined physical factors also is in danger of ignoring commercial risks entirely, which is not an appropriate result for any transfer pricing exercise. It is hard to conceive how a single set of profit split factors could be appropriate in all possible cases, given the different contributions to profit which exist in different businesses.

As with Option 2, there is no policy justification to reallocate the entire profit to parties other than the minimal functional entity. There is no basis to ignore completely whatever contributions the entity makes, even if they are relatively minimal in relation to other contributions. This is especially the case as the proposed definition of a minimal functional entity proposes that the entity may not be so “minimal,” as the Option suggests that the entity may have employees and valuable assets. It seems that the main purpose of this Option is to reallocate risks, given that the entity in fact has functions and assets. If that is the main purpose of this Option, then that issue is being addressed directly in the work on risk and recharacterization.
The alternative to reallocate the profit to the parent is more consistent with CFC policy than transfer pricing principles. As the parent had made the investment in the entity, this is a more appropriate result than an allocation to other entities in excess of their actual contributions to value. We believe an allocation to the ultimate parent of the group (consistent with CFC policy) is more appropriate than an allocation to the direct parent of the minimal functional entity, if that entity is not the ultimate parent.

Since this special measure would seem to operate as a “cliff,” the “minimal functional entity” threshold determination needs to be stated with extreme precision.

The scope and effect of this special measure extends far beyond addressing the residual risks of information asymmetries or the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities. Indeed, the main focus of this Option seems to be the allocation of risk as well as capital. Since this special measure could potentially reallocate income arising not just from capital, but even from some functions and risks, this special measure seems to be operating far beyond the parameters set by the Discussion Draft itself for any special measure.

The effect of this special measure on taxpayer behavior will be to provide incentives to increase employment and assets in the minimal functional entity in an effort to achieve the “minimal functional entity” threshold, even if not entirely justified from a business perspective.

5. Option 5: Ensuring appropriate taxation of excess returns

Since the principal rule of this Option is an income allocation to the parent, the conceptual justification for this Option lies in the area of CFC policy. There is little relationship to the application of the arm’s length principle, as the definition of income affected has no connection to the actual commercial transactions undertaken by the CFC. Instead, the trigger is stated solely in terms of the effective tax rate.

There is less justification for the secondary rule than the primary rule, as there is no reason to over-reward entities operating in other jurisdictions if the parent jurisdiction chooses not to exercise its right to tax those excess returns under its CFC rules.

This special measure operates outside the parameters set by the Discussion Draft for considering special measures. There is no suggestion that this special measure is meant to address information asymmetries, and the proposed reallocation can occur even in cases where the capital funding was entirely proper under whatever standards are meant to apply to that determination. Accordingly, any further development of this Option should proceed under Action 3, regarding strengthening CFC rules.
The effect of this special measure will be to cause groups to shift investment and operations to jurisdictions with a tax rate at least equal to the stated threshold percentage, if that rate is significantly less than the ultimate parent home jurisdiction rate.

C. Conclusion

The introduction of a “special measure” will be an extraordinary event in the law of transfer pricing. Those special measures that are outside the arm’s length principle will require domestic legislation and treaty amendments to implement into law.

The problems sought to be addressed by the five Options would seem to be covered by one or more of the revisions to the Guidelines contemplated in the work under Actions 8 - 10, as well as other elements of the BEPS project such as Action 3 dealing with CFC reform. The Options are all endeavors to create a result by short circuiting the otherwise applicable factual and comparability analysis mandated by the Guidelines. We suggest that such a radical departure from established transfer pricing guidance should not be rushed into place under the accelerated timetable of the last few months of the BEPS project.

We believe that there is no prudent way to approach the question of whether special measures are needed without taking the time to assess whether the rest of the BEPS Action Plan will have its desired result. If they do not, then WP6 can reengage on special measures at such point as it is clear that special measures will be needed to achieve the results agreed upon in the BEPS project, despite the implementation of the rest of the BEPS project.

If, however, an Option must be chosen in the last few months of the BEPS project, we believe that Option 1 (HTVI) could, if suitably modified, be a practical modification to the Guidelines for WP6 to endorse.

* * *
The Treaty Policy Working Group hopes that these comments will be helpful as deliberations continue on these important issues. We would welcome the opportunity to participate in the consultation on these and other transfer pricing issues on March 19-20.

Sincerely yours,

For the Treaty Policy Working Group

Carol A. Dunahoo

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Gary D. Sprague
Via e-mail: TransferPricing@oecd.org

Mr. Andrew Hickman
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Dear Mr. Hickman:

BEPS Actions 8, 9 and 10: Public Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (Including Risk, Reclassification and Special Measures)

For your review and consideration, we are writing to provide our comments on the BEPS Actions 8, 9 and 10 Discussion Draft ("Discussion Draft") released December 19, 2014. We are providing both detailed comments as well as an Executive Summary.

Transocean is a leading international provider of offshore contract drilling services for oil and gas wells. The company specializes in technically demanding sectors of the global offshore drilling business, with a particular focus on deep water and harsh environment drilling services. The company operates one of the most versatile offshore drilling fleets in the world. With business operations in over 50 countries, we support clear, consistent and stable transfer pricing policies and international tax principles.

After reviewing the proposals and detailed material contained in the Discussion Draft, we are concerned that these proposals significantly undermine the long standing and widely accepted arm’s length principle and subjectively recasts appropriate transactions. As a result, these proposed transfer pricing guidelines may fail to provide appropriate returns to asset owning entities in our industry, and potentially other industries as well, and, contrary to the stated goals in the Discussion Draft, may result in transfer pricing outcomes that are misaligned with value creation.
We appreciate your consideration of these important issues and would be pleased to discuss them further with you. I respectfully request the opportunity to further address these issues at your March 19-20 public forum.

Yours sincerely

[Signature]

Stephen L. Hayes
Sr. Vice President - Tax
Executive Summary of Comments on Discussion Draft

I. The Proposals Hinder Cross Border Trade by Increasing Subjectivity & Uncertainty

Capital intensive businesses such as the offshore drilling industry must make long-term capital investment decisions and thus need clarity and stability regarding taxation. The Discussion Draft creates significant uncertainty as to the application of transfer pricing rules due to the subjective nature of the transfer pricing proposals, non-recognition provisions and special measures. This undermines the arm's length principle, erodes business confidence and may result in reduced global trade and cross-border investment.

II. Any Proposals Must Affirm Appropriate Business-Driven Structure and Substance

In order to align income tax outcomes with economic and commercial substance, entities making substantial investments in tangible assets must be respected and allowed to expect to earn over the life of the rig a return commensurate with the investment and risk undertaken and to earn actual returns in any given year that reflect the outcome of business risk in that year; otherwise, such investments will become uncompetitive and be curtailed. This should hold true regardless of the extent of the level of activity required to manage those assets.

We understand that a significant objective of the Discussion Draft is to propose transfer pricing rules to prevent the artificial movement of profit generating activities among jurisdictions. But in doing so, the rules should not impair the movement of assets and activities that is necessary to compete in particular industries. The offshore drilling business is unique in that the drilling rigs are mobile and move as a matter of course between taxing jurisdictions based on customer needs and market conditions. For this and other good commercial reasons, it makes sense to separate the ownership of the drilling rigs from the group’s local in-country entities which operate the drilling rigs. Owning the rig in the country of operations would require repetitive transfers of ownership as rigs move from country to country, creating the potential for the imposition of multiple capital gains taxes and double taxation. Further, in many jurisdictions, a locally incorporated entity is specifically required in order to conduct drilling operations in that jurisdiction. This creates the need for the rig owning entity to lease the drilling rig to the group entity operating the drilling rig (the “Operator”) under what is called a “Bareboat Charter”, or “BBC”. The use of a BBC is the industry’s typical way of operating. In fact, the BBC has been widely accepted by tax authorities around the world.

The drilling rigs are typically owned by an entity, the business of which is leasing the rigs (the “Owner”), in a jurisdiction which offers legal and commercial ease and flexibility and, to minimize the possibility of multiple layers of taxation, levies little or no tax. These Owners have offices, employees and all other required resources that are necessary to undertake the relevant leasing activities. Thus, the Owners have the appropriate substance required to fully operate their business. The fact that the leasing business does not require a substantial number of people to operate should not serve as a basis to disallow such entities from earning a return.
sufficient to recover the substantial capital investment in the rig and a risk-adjusted arm’s length return.

III. Inappropriate Returns Allocated to Risk Management and Control

We are very concerned that the Discussion Draft inappropriately allocates excessive returns to risk management and control. In particular, we believe the example in ¶ 63 is incorrect, especially in regards to the drilling industry. The Owners make up-front investments in the hundreds of millions of dollars per rig and bear the significant risk of underutilization of the rig during its life and/or less than expected cash flows when the rig is operating. The Operator, in turn, has primarily variable costs and is much more able to control its risk. While not the intent, we believe the practical effect of the Discussion Draft for the drilling industry could result in the re-allocation of the upside to the Operator while leaving the downside risk with the Owner. We fundamentally disagree that risk allocation should not be respected when the use of the asset is dependent on another party or if risk management and control is exercised by another party for sound business reasons. There are many market based examples where an asset owner bears the financial risk of the investment while relying on another party for utilization and/or management and control of the risk, and they are outlined in our detailed comments.

IV. Avoid Subjective Use of Non-Recognition

While we believe BBCs by an Owner to an Operator reflect the fundamental economic attributes of arrangements between unrelated parties, we are concerned that the proposed non-recognition provisions could be broadly, subjectively and inappropriately used by tax authorities to second-guess legitimate business transactions. We fear a significant increase in tax controversy matters due to the subjective and arbitrary use of proposed non-recognition. We recommend that such non-recognition be applied only to arrangements that are wholly artificial and would request that an example be included from our industry that affirmatively recognizes and respects the logical and necessary separation for business reasons of the ownership of property from its use.

V. Special Measures should be Removed

We believe any actual or perceived abuses can be more than adequately addressed by application of the arm’s length principle. We believe the Special Measures represent a fundamental departure from the arm’s length principle and would create many transfer pricing disputes not subject to resolution under the mutual agreement procedure. If adopted, we believe such measures would introduce significant uncertainty and subjectivity, result in unequal application among taxpayers and result in uneconomic transfer pricing results. We strongly urge that such measures be eliminated entirely from the Discussion Draft. Nonetheless, our specific comments on each proposed measure are included in our detailed comments. If Special Measures are to be adopted, these should only apply where transactions have been undertaken with a clear tax avoidance motive with contrived structures. BBC arrangements for industries with moveable assets would therefore be explicitly excluded.
I. The Proposals Hinder Cross Border Trade by Increasing Subjectivity & Uncertainty

The offshore drilling industry, like many other industries, is a highly capital intensive business, involving significant, long-term investments in drilling rigs. Accordingly, the industry needs clarity and stability regarding taxes in order to make major capital investment decisions. A new drillship capable of operating in 12,000 feet of water might cost as much as US $900 million. A new harsh environment drilling rig capable of working in the North Sea might cost as much as US $650 million. Both may take three or four years to construct. For any major capital investment, the business needs to have reasonable clarity and confidence in how future income will be taxed. The Discussion Draft creates significant uncertainty as to how the transfer pricing rules would apply due to the subjective nature of the proposed transfer pricing rules, non-recognition provision and special measures. The introduction of and reliance on subjective determinations undermines the widely accepted arm's length principle, thereby eroding business confidence. This, in turn, may adversely impact global trade and cross-border investment.

II. Any Proposals Must Affirm Appropriate and Valid Business-Driven Structures and Substance

As part of the BEPS transfer pricing project, there has been much public discussion of the role and legitimacy of entities established in jurisdictions which levy little or no tax. The desire to eliminate "paper companies" with minimal, if any, substance is understandable. However, in order to achieve the BEPS aim of aligning income tax outcomes with economic and commercial substance, entities that make substantial investments in real assets must be allowed to expect to earn over the life of the rig a return commensurate with the investment and risk undertaken and to earn actual returns in any given year that reflect the outcome of business risk in that year; otherwise such investment will become uncompetitive and be curtailed. This outcome should hold true even where the level of activity required to manage those assets is relatively modest.

Transocean conducts its business by owning and operating drilling rigs. As noted above, our rigs represent a very substantial investment for our enterprise, often costing hundreds of millions of US Dollars. Accordingly, the balance sheets of some of our larger affiliates that own drilling rigs reflect investments of billions of US Dollars. Unlike transfer pricing arrangements in some other industries which have recently received negative attention and scrutiny in the press, there is no controversy regarding whether the value of the assets owned by the rig owning affiliates is consistent with the arm's length standard. We often contract with third party shipyards to build our rigs; consequently there are clear, unambiguous, third party market values for these assets. On occasion, we purchase a rig from a third party drilling company. Furthermore, there are a sufficient number of third party sales of drilling rigs each
year to clearly assign the value of a rig over time. So again, there is no dispute as to the value of the rig.

Our affiliates which are engaged in the provision of drilling services using mobile drilling rigs market their services around the world – not to belabor the obvious, but our rigs must be transported to where our clients want to drill. In general, the usage of a rig is not jurisdiction specific. A given rig may be put to use in the UK Continental Shelf under one contract but then moved to Norwegian waters, for example, for the purposes of performing a subsequent contract. A given drill ship may be put to use in the deep water of the US Gulf of Mexico under one contract but then moved to Angola for a subsequent contract. Our drilling rigs move in response to customer needs or market conditions. Furthermore, it is not uncommon for our customers to seek to move our drilling rig from one location to another during a single contract. Often, our customers seek to relocate a rig on short notice. It is this customer-driven asset mobility which makes our industry unique. Over its useful life, a drilling rig may operate in a number of jurisdictions. Some of our drilling rigs have operated in over a dozen countries.

Given the mobile nature of the rigs, it does not make business sense for the rigs to be owned in the jurisdiction in which any single contract is performed, if for no reason other than the imposition of capital gains tax on the value of the rig when it moves from one country to another. The change in market value of a rig can swing wildly depending, upon other factors, on the fluctuations in oil prices and the demand for drilling services. Such value movements generally are not related to the activities in a particular country of operations. Further, such value movements, if to the downside, could result in substantial losses which taxing authorities may be reluctant to accept. It also makes sense from a legal liability perspective to separate the ownership of the rigs from the operatorship of the rigs, especially given that the property ownership laws in many of the jurisdictions in which we operate do not provide what we believe are adequate protections. Instead, the most practical pattern of business operation is to have one affiliate own one or more drilling rigs and lease the rigs to operating affiliates incorporated in and/or operating in the jurisdictions where drilling takes place (“Operators”).

Further, many countries in which Transocean operates require a locally incorporated company to operate the drilling rig. For example, Malaysian rules require that a locally incorporated Malaysian company enters into the drilling contract with the client and performs the drilling services. This requires that the rig owner (the “Owner”) lease the drilling rig to the local (Malaysian in this case) operating company. Traditionally these leases have been referred to as a bareboat charter agreement (“BBC”), which is a term lease of the rig without a crew. The BBC is widely adopted within the drilling industry and separates rig ownership from rig operation. In addition to meeting local law requirements, as described above, such separation is crucial for maintaining flexibility as rigs move between jurisdictions, reducing the risk of double taxation, protecting the rigs against contractual or other legal liabilities and managing other risks.

For these reasons, Transocean and other drilling companies typically own many of their rigs in a jurisdiction which offers legal and commercial certainty, ease and flexibility as well as levies little or no tax. As noted, this is important for avoiding double or even triple taxation. Many
jurisdictions where we operate impose taxes based on “deemed profits” (a tax based on the corporate income tax rate multiplied by an assumed profit rate and then applied to gross revenues). Additionally, many of the taxes we incur might not qualify as a foreign tax credit, thereby also resulting in double taxation.

It is important to note that any Owner in a tax neutral jurisdiction forgoes any tax benefit for depreciation on the capital cost of building, acquiring, or upgrading the rig, any interest expense incurred in financing the acquisition or construction of the rig, any loss on disposition of the rig and, in general, any tax benefits from expenses or losses incurred while the rig is idle and not working or when cold stacked.

Our Owners possess the appropriate substance given the nature and requirement of the business, including offices, sufficient employees and all other required resources to undertake the relevant leasing and other activities. These employees possess the skills and capabilities as well as the industry experience necessary to capably manage the leasing, financing, asset management and legal issues facing a rig owning business.

Lease payments made by the Operator to the Owner are set on an arm’s length basis, in full compliance with the OECD transfer pricing guidelines and in many cases are agreed with the appropriate tax authorities through advance pricing agreements. Leasing payments received by Owners thus reflect a risk-adjusted return that is commensurate with their investment in the rigs and associated risks, which is an amount sufficient to pay off any debt incurred in the purchase, construction or upgrade of the rigs and to ensure that the Owner earns an arm’s-length return on its investment given the substantial capital invested and high level of risk assumed.

This sensible business model is neither "aggressive" nor "abusive" tax planning; it simply means that the tax burden directly follows the economic and commercial substance of the ownership and use of the rigs. In the absence of any tax considerations, this business model would still be used.

Conversely, we are concerned that the transfer pricing rules proposed in the Discussion Draft depart significantly from the economics practiced between providers of tangible assets and users of tangible assets in the marketplace. From an economic return perspective, and despite the risk of ownership never transferring from the Owner to the Operator, the Discussion Draft in many cases would essentially treat the BBC as a capital lease rather than an operating lease, the legal and economic form of the lease. Capital leases call for full amortization of the lessor’s investment, plus a rate of return on the lease that resembles the percentage rate the lessee would have paid on a secured loan. Despite the fact that Owners incur substantially more risk and the BBCs involve operating leases rather than capital leases, we are concerned that the Discussion Draft may deny the Owners an appropriate, risk adjusted, expected return, let alone a return in any given year that might be surplus due to favorable market conditions, or deficient in a weak market. A new build drilling rig typically has a useful life of 35 years or more. The term of the BBC is not 35 years, but a series of BBCs that most likely will never exceed five
years, most of which are for shorter period of two years or less. A given rig will likely be leased under many BBC’s over its life. However, the Owner will likely incur substantial periods of time between BBCs where it earns no return at all. Before and after the period of a BBC (before the Operator starts drilling operations and after Operator concludes drilling operations), there is no BBC in place and the Operator has no obligation to pay for the rig. Consequently, it is the Owner who has the utilization risk. For the Owner, “utilization” is one of the keys to successful business outcomes given their huge investment in the rig. The Operator does not share this type of risk.

Given all of the above, the actual risk profile of the Owners bears no resemblance to the risk profile suggested in the Discussion Draft, which it would re-allocate from the Owner to the Operator. Similarly, the Operator of the rig bears much less risk that the Discussion Draft would suggest. The Operator controls the risks of its own business, expanding or reducing its own operations according to the length and number of drilling contracts it has been able to secure with oil companies. In times with low or no activity it may reduce activity or hibernate. The Operators have highly variable costs which can be recued during periods of inactivity (as compared to the significant sunk costs incurred up-front by the Owners). The Operators negotiate a lease rate which reflects the specific economics of the drilling contract. Given the high variability in drilling rates (due to the highly cyclical nature of the industry), having a BBC rate that reflects that particular contract (versus a fixed BBC rate over 35 years) significantly reduces the risk profile of the Operator. Again, the bulk of market risk falls on the Owner - not the Operator.

This risk (and associated potential for a reduced return) for the Owner is even more pronounced today given that a number of new build drilling rigs are entering the market. Since January 1, 2010 there have been 336 offshore drilling rigs ordered by the industry (representing a combination of drill ships, semi-submersible rigs and jack-up rigs), 121 of which have been delivered as of January 31, 2015. This development has resulted in many older rigs being unable to secure work. When a rig is unable to secure work for an extended period of time, it may be “cold-stacked” (where the rig is anchored in a harbor or shipyard and the rig is completely shut down, with steps taken to protect the rig during an extended period of inactivity). Once a rig is in fact cold-stacked, it generally requires a substantial incremental investment by the Owner to get the rig ready to work again. Because there are so many idle rigs currently being cold stacked, a significant number of rigs have been scrapped and will never work again. Today, over 1 out of every 7 rigs in the industry is idle or stacked. Almost 10% of
all rigs industry-wide are cold-stacked, some of which may not ever work again.\footnote{Data obtained from ihs.com as of 4 February 2015. Of the total 728 drilling units comprising drill ships, semi-submersibles and jack-ups, 110 were idle, including 5 out-of-service, 39 “warm-stacked” and 66 cold-stacked.} These numbers are likely to increase significantly over the coming months. It is easy to see that the Owner faces substantial business risk not present for an Operator.

In order to maintain consistency with the arm’s length principle, we encourage the OECD to remain faithful to the important established economic principles that are plainly and broadly observable across markets. One important principle in this regard is that in the open marketplace, in transactions involving unrelated parties, providers of tangible assets (particularly expensive, high technology tangible assets, like drilling rigs) are oftentimes entitled to significantly more arm’s length compensation than the operators of those assets. The Discussion Draft, in comparison, would allocate most profits to labor and management inputs. We do understand that, from time to time, tax authorities and drilling companies can’t agree on a precise transfer pricing outcome, but we routinely and consistently resolve those instances by reaching mutual agreement under existing transfer pricing guidelines and practices.

Given our business operating model, we have several concerns with specific proposals in the Discussion Draft which are outlined below.

III. The Discussion Draft Inappropriately Re-allocates Risk and Associated Returns

We are concerned that Section D.2 of the Discussion Draft, which relates to the role of risk control and management in transfer pricing, asserts that a related party’s assumption of a business risk should not be respected where it does not have the capabilities to manage or control that risk. We believe this conclusion is incorrect, inconsistent with economic principles and could lead to inappropriate re-allocations of risk and returns by tax authorities for our industry and others which are not consistent with the commercial realities. In particular, we believe the example in ¶ 63 of the Discussion Draft is incorrect, especially in regards to the drilling industry.

As previously noted, the biggest downside business risks in the drilling industry are the risks that the rigs will: (a) be idle without work (and thus earning no revenue); (b) earn significantly reduced revenues during an industry downturn; or (c) become obsolete before the end of their useful lives due to new build rigs displacing them or for other reasons. The Owners very clearly bears these risks. If the risk of idle rigs, either due to a downturn in the business or due to technological obsolescence, is shifted to the Operator, then the Operator must pay a BBC to the
Owner for an idle rig. Otherwise, significant downside risk remains with the Owner, and that is 
clearly inconsistent with putting the upside risk with the Operator. As a practical matter, 
however, the taxing authorities in the Operator's jurisdiction will never allow a deduction for a 
BBC paid for an idle rig. Thus, the practical effect of an attempt to shift risk to the Operator will 
be to shift only upside risk to the Operator while leaving significant downside risk with the 
Owner, which is a result clearly inconsistent with the arm's-length standard.

A group company which operates the rig will lease the rig from the Owner only when it has a 
drilling contract and then only for the term of the drilling contract. It will base the rental rate it 
is willing to pay based on the revenues and other costs it will earn and expects to incur under 
the drilling contract. If there is no work following the drilling contract, it is the Owner, and not 
the Operator, which has made the "sunk cost" capital investment in the rig for which it earns no 
cash flows. If there is work but at a lower rate, it is the Owner which will largely bear the lower 
cash flows. The Operator will pay a reduced rental for the rig based on the reduced drilling 
contract revenues. It is thus the Owner and not the Operator which is the primary risk taker.

As correctly noted in ¶ 63 of the Discussion Draft and discussed above, utilization of the rig and 
associated rental rates is a core risk impacting the Owner's income stream. However, the 
primary driver for the utilization of the rig and the associated pricing is the level of drilling 
activity, which in turn is dictated by oil prices. Figure 1 on the following page plots the 
utilization rate of offshore drilling rigs for the period spanning from January 1, 2005 through 
December 31, 2014 against the average annual West Texas Intermediate ("WTI") crude oil spot 
prices observed over this same time period. Figure 1 shows a strong correlation between 
trends in crude oil prices and rig utilization across the contract offshore drilling space.

Oil prices are influenced by a wide variety of factors that are clearly out of the control of either 
the Owner or the Operator. While certain risks may be managed and controlled, neither party 
has the ability to control or influence what is perhaps the single most important business risk 
that the industry faces. Instead, oil prices are properly characterized as an exogenous financial 
risk.

Utilization of the rig is therefore less of a function of roles and activities of the Operator but 
more driven by aggregate demand for drilling services, which is highly correlated with the price 
of oil. As such, the Operator is not performing a risk management and control function which 
effectively mitigates the volatility of business profits. For this reason it is clearly inappropriate 
to allocate a significant portion of the profits to management and control of risk by the 
Operator as is suggested by ¶ 63.
Further, an Owner is able to lease its drilling rig to any of multiple group Operators and is thus not dependent on any particular Operator in order to exploit its asset. It thus cannot be concluded that any particular Operator is contributing any premium value. In fact, the technical capabilities of the drilling rig itself, along with pricing, are among the most important criteria customers use when selecting a drilling contractor. It is the third party customers who dictate the specifications for the equipment – not the related Operator. In the offshore drilling industry, it is the substantial, high-risk investment in the drilling rig which is the primary value driver.

We believe the conclusion reached in the Discussion Draft that risk cannot be borne without having control and capabilities to manage that risk is also inconsistent with third party transactions. In the real estate industry, for example, it is very common for property owners to outsource the management of the property, including risk management, such as assessing and managing credit risk related to the lessee, to a third party for a fee. The third party earns a fee and does not earn the majority of the profits earned by the property owner. Similarly, a "net lease" in the real estate industry is very similar to the BBC in the drilling industry. Such lessors can and do earn substantial returns as compared to the financing returns referred to in the Discussion Draft. Property owners are often dependent on a leasing agent or management
company to exploit their rental assets. For example, in the hotel industry, the property owner hires a third-party management company to manage the property and is dependent on such management company in order to exploit its valuable asset. Most of the economic risk is borne by the property owner rather than the management company. In the drilling industry, the property owner (rig owner) also bears significantly more risk than the Operator.

In essence, we believe the Discussion Draft fundamentally and inappropriately deviates from the laws of economics and the results observed in unrelated party transactions in concluding that rigs and other tangible assets should earn something like a financing return (at best) and that all returns above that should be attributed to people functions (labor). Transactions between related companies should not be treated more favorably as compared to third party transactions, but neither should they be disadvantaged.

The drilling industry is a high risk, highly cyclical business. If the price of oil is high, drilling activity generally increases and the demand for rigs is high. If oil prices decline for a substantial period of time, demand for rigs generally declines. As a result, the drilling industry faces business risks on pricing of drilling services, the ability to obtain drilling contracts, and the value of its drilling rigs. In such a business, it makes sense for the lease rates between the Owner and related Operator to reflect the underlying economics of a drilling contract rather than having rates that are fixed over good and bad times. This transfer pricing policy preserves the incentive of Operators to maximize their profits while minimizing the potential for both trapped losses and excess profits in the Operators across different economic environments. This approach has been widely accepted by tax authorities around the world. We believe the risk discussion in Section D.2 should acknowledge the appropriateness of such arrangements.

The oil and gas industry is currently experiencing a major downturn. This, in turn, is causing the drilling industry to experience an even more severe downturn, with significant decreases in rig utilization, substantial decreases in pricing for drilling services, significant decreases in rig values, and substantial decreases in stock price and market capitalization. As of January 15, 2015, 11 of our rigs were idle and earning no revenue. Further, Transocean has announced its intent to scrap (destruction of rig in an environmentally sensitive manner for value of scrap metal components) an additional 12 drilling rigs (combined total of 23 rigs currently earning no revenue). Consistent with our transfer pricing methodologies, these business risks (and associated loss of value) fall on the Owners. If the Discussion Draft forces the Operator to appreciably share the negative economic consequences of this downturn (which must be the case if the “upside” returns are to accrue to the Operators), then tax authorities should prepare for the substantial tax losses to be generated in the country of operations, generating tax losses that will eliminate any cash tax payments for years to come. Historically, tax authorities have strongly resisted this outcome and charged the Owner with bearing most of the economic results - good or bad.

We see several problems with approach taken in the Discussion Draft. First, as outlined herein, we do not believe it reflects the economic reality and risks actually borne by each party. Second, the Operator is less able to withstand the down-cycle than the Owner and is more
likely to become financially distressed. Lastly, given the unique nature of our industry and the fact that the rig may be leased to several Operators, how are the losses during a down cycle to be allocated among the Operators? Assume, for example, that an Owner leases its drilling rig to affiliated Operators X, Y and Z for 2 years each. At the end of year 6, the rig becomes idle for a two year period. How are the losses in years 7-8 to be borne by Operators X, Y and Z? As a practical matter, we believe application of the Discussion Draft would result in the Owner being left with the losses in the down-cycle while returns during the up-cycle would be re-allocated to the Operators.

We believe addressing the concerns described above will not give rise to base erosion in any meaningful sense and any concerns are more than adequately dealt with in other Action Items. Entities that make investments in tangible assets and take risks must be respected and allowed to earn a reasonable return in order for an income tax to be true to its fundamental premise of taxing net income. The fact that it makes business sense to separate the ownership of high cost assets from the business use of those assets does not affect this fundamental premise. We urge that revisions to the draft be adopted to assure such investments are respected and allowed to earn an appropriate return.

Other areas of concern in Section D.2 of the Discussion Draft include:

**Moral Hazard**

The Discussion Draft introduces the concept of “moral hazard” into the transfer pricing analysis, which it defines as the lack of incentive to guard against risk where one is protected from its consequences. The Discussion Draft uses the concept of moral hazard as further basis to allocate (or re-allocate) risk in related party transactions based on which entity manages and controls the risk.

We fundamentally disagree and believe incentives and safeguards in related party contracts are not required because, among related parties, incentives are generally aligned. As such, it is not necessary to have those safeguards, and it would be inappropriate to disregard a transaction among related parties that did not include such provisions, nor to re-allocate the risks borne by each party based upon an application of moral hazard and which entity manages and controls the risk.

**Risk-Return Trade-Off**

We are also concerned that the proposals in the Discussion Draft would allow a transaction to be disregarded simply because a related company foregoes a riskier but potentially higher return stream of income in exchange for a lower risk but lower return stream of income with the same expected risk-adjusted net present value. We believe businesses routinely make such risk–return trade-off decisions and transactions between related enterprises should not be disadvantaged as compared to third party market transactions.
IV. Avoiding Subjective Use of Non-Recognition

Given our industry and business model, we have several concerns with the Discussion Draft with respect to non-recognition. First, it is important that Section D.4 Non-Recognition (¶ 83 - 93) be read to conclude that drilling rig owning arrangements like those described herein would be recognized by tax authorities in countries where the rigs are operated. The general concept articulated in ¶ 88 and 89 that Non-Recognition is to be applied where the "fundamental attributes of arrangements between unrelated parties is lacking", is helpful because we believe bareboat charters of drilling rigs reflect those "fundamental attributes" of arm's length arrangements. Moreover, our group of companies overall is definitely not worse off by separately owning and leasing our rigs given the non-tax as well as tax difficulties of transferring rig ownership from jurisdiction to jurisdiction as its country of use changes. While clear distinctions from the trademark ownership example included in ¶ 90 and 91 can be made, we have legitimate concerns that Non-Recognition could be broadly, subjectively and even inappropriately used by tax authorities to second-guess legitimate business transactions. Such action would lead to greater tax controversy and litigation, and of course, further undermine economic confidence by business. As such, we would recommend that non-recognition be applied only to arrangements that are wholly artificial. We would also respectfully request that an example be included from our industry or another industry that expressly acknowledges the validity of separating the ownership of property from its use for good business reasons. Such an example could be extremely helpful in drawing reasonable lines around the application of the Non-Recognition concept. For your review and consideration, we have included a draft example as Appendix A.

V. Special Measures should be Removed

Finally, we are very concerned with the “Special Measures” proposed in Part II of the Discussion Draft. In general, we believe that any actual or perceived abuses can be more than adequately addressed through the arm's-length principle and believe the special measures represent a substantial departure from that principle. Such measures, if adopted, would introduce significant uncertainty and subjectivity and result in unequal application among taxpayers and result in uneconomic transfer pricing results. As such, we urge that the Discussion Draft's PART II - Potential Special Measures not be adopted. The special measures are only very briefly described and we believe there is simply not enough time remaining in the BEPS project to properly consider them and avoid significant negative consequences. At the very least, we recommend that consideration of the need for special measures be deferred until work on other BEPS measures has been completed and can be evaluated holistically. Still, our specific comments on these special measures are summarized below.

Option 2: Independent Investor

Similar to non-recognition discussed above, Option 2 would allow taxing authorities to ignore the actual transaction (facts, contracts, entities, pricing, responsibilities, etc.) and instead
recharacterize the transaction and treat the drilling rig as owned either by the Operator or by a parent company, with the result that an inappropriately and unreasonably low return would be allowed to the Owner. As outlined above, such a proposal ignores the legal and commercial realities of the business conducted and risks borne by the Owner. The fact that a group company may rely upon another group company to utilize its assets does not change this result.

Option 3: Thick Capitalization

We are concerned with a misapplication of Option 3, Thick Capitalization, to Transocean's facts because we typically do not have debt in our rig owning entities. For good business reasons, our third party debt is primarily held in a finance entity dedicated to raising debt capital and investing it around the group. This finance entity is incorporated and based in a tax-neutral jurisdiction. Therefore, with our business structure not resulting in a tax benefit, it is very clear that this separation of our borrowing function and our rig-owning function is not tax driven. Yet the Thick Capitalization proposal would seem to allow some other jurisdiction to claim a portion of the rig-owning entity's income as its own. In our view, this is an inappropriate result and should not be adopted. As is well described in the Discussion Draft on Action 4 (Interest Deductions and Other Financial Payments), transfer pricing generally and the arm's-length standard in particular provide little guidance regarding the appropriate capitalization of group affiliates. Interest limitation regimes like those considered in the Action 4 Discussion Draft are already addressing issues related to excessive capitalization just as they deal with thin capitalization issues. At a minimum, if Option 3 is adopted, it should make clear that Thick Capitalization does not apply to an asset owning or finance entity where affiliates in the same or similar low tax jurisdictions are funding group third-party debt.

Option 4: Minimal Functional Entity

Similarly, the draft Special Measure Option 4, Minimal Functional Entity, is also a concern. As described above, the rig ownership and leasing business requires few employees, deals entirely with group companies, and has a high asset value compared to its income. The Discussion Draft has recognized that “while one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transaction that is important”. See Discussion Draft, ¶ 16. In our industry the most significant value driver is the substantial investment in the drilling rig, an activity conducted by the Owner.

Perhaps this option was intended to overlap with the Non-Recognition concept discussed above and thus is limited in application to entities that do not have the "fundamental economic attributes of arrangements between unrelated parties" (¶ 88). If so our comments above regarding the need to restrain the application of that concept apply equally here. But we worry something broader could be intended here. In any case, we strongly recommend either that Option 4 be rejected or that it be limited to arrangements that are wholly artificial and uneconomic absent tax considerations. Examples distinguishing such entities from typical
asset-owning entities and finance entities that undertake all activities necessary for their business would be useful. We propose a reference to the example under our new proposed ¶ 90(a).

**Option 5: Ensuring Appropriate Taxation of Excessive Returns**

Option 5 would subject “excess returns” (measured over a 3 year period) of a CFC to taxation either by a parent company, or if no parent actually taxes such excess returns, to taxation by other jurisdictions based on a predetermined allocation rule. We believe there is significant potential for abuse with such a rule. It is likely that multiple jurisdictions could claim taxing rights over such income and tax disputes will rise exponentially. Further, in the drilling industry, such use of an arbitrary 3 year measurement of excess returns can lead to distorted results. As noted herein, the drilling industry is highly cyclical. During a period of high oil prices, an Owner may earn high returns. Conversely, in an industry downturn, the Owner may earn substantially lower returns, or no returns at all if the rig is stacked and earning no revenues. Over its 35 year life, the Owner of the rig expects to earn an arm’s length return, but such return will be highly variable. Option 5 would result in the earnings in the “good years” being re-allocated, but the losses or low returns in the “bad years” remaining with the Owner. For the highly cyclical drilling industry, a period of ten years would be more appropriate.

**Questions Posed:**

In view of the above discussion, we provide below our response to question 9 of the framework (for questions on all options on page 40 of the Discussion Draft):

**Question:** Should certain sectors be excluded from the application of the measures?

**Response:** For all of the reasons outlined herein, we strongly believe that the special measures should not apply in the case of BBC arrangements within the offshore drilling industry. The structure is in place for valid business reasons, the transfer pricing is arm’s length and there exists adequate substance given the nature of the business conducted. We believe that tangible assets like drilling rigs, factories, laboratories, high-tech equipment, etc. create “value” and can be appropriately priced under the arm’s length principle, and are thus not appropriate candidates for application of special anti-abuse measures.
Appendix A – Proposed Paragraph 90(a) Insert to Discussion Draft

Company R is a subsidiary of a multi-national group ("Group") and specializes in building and/or acquiring high value equipment and leasing such equipment to affiliates in the group. Company R has offices, sufficient employees and all other required resources to undertake the relevant leasing and other activities it conducts, including employees responsible for leasing the equipment and managing the financial aspects of the business, and employees responsible for managing the equipment (including capital expenditures and upgrades and similar investments to keep the equipment marketable). Affiliates of Company R provide certain support functions such as accounting, engineering, IT and HR. Company R engages in a leasing arrangement whereby the equipment is leased to its affiliated Group companies ("Operators"). The terms of the lease provide that company R provides the equipment to the Operators without any associated services or employees and that the Operators provide insurance and maintain the equipment. The Operators contract with third party customers to use the equipment and their own employees to provide services in different countries. Generally, Company R does not directly engage with third party customers in contracts for multiple reasons, among which include: the protection of the equipment against contractual and other legal liabilities; the safeguard of a valuable flexibility to move the equipment between countries under relatively short notices and without going through costly and complex country specific administrative procedures; and the protection against potential capital gains and exit taxation generally incurred with every change in the country of operation.

The scenario set out in this paragraph demonstrates that the separation of the ownership of the equipment from their operation is based upon sound business reasons. The leasing arrangement does exhibit the fundamental economic attributes of arrangements between unrelated parties in that it protects the financial position of company R (through mitigation of the risks associated with the contractual and other liabilities) and enhances the financial and commercial position of the Operators (through the generation of income when using high value marketable equipment that the Operators could not have otherwise afforded with its light-capital, personnel-based structure). Also, the lease makes the Group overall better-off on a pre-tax basis by allowing flexibility to grasp business opportunities in different countries and by avoiding administrative and legal costs which would have been otherwise incurred every time the Group decides to pursue an opportunity in a different country. Finally, for the same reasons mentioned above, the alternative of not entering into the leasing arrangement (being to own and operate the equipment by either of the companies) is not offering a realistic option of enhancement nor protection to the financial or commercial position of the parties.

Under such circumstances, the leasing arrangement cannot be disregarded for transfer pricing purposes.
VIA EMAIL
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Re: USCIB Comment Letter on the OECD Discussion Draft on 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 Mr. Hickman,

USCIB is pleased to have this opportunity to provide comments on OECD’s discussion draft on risk, recharacterisation and special measures.

**General Comments**

**Special Measures**

USCIB is very concerned about the proposed special measures. The special measures presented in the discussion draft are only described at a very high-level and it is therefore impossible to analyze them and comment on them in any detail. Before adopting any of these options it would be necessary to publish comprehensive drafts with more specific detail and permit an extended period of stakeholder input into those comprehensive proposals.

USCIB believes that none of the special measures should be adopted until the other BEPS measures have been fully implemented and the need for any additional special measures to target specific issues can be assessed. The discussion draft asserts that residual BEPS risks will remain even after other proposals are implemented and that this expectation justifies special measures. The BEPS proposals are intended to align returns with value creation. The various measures that are being developed in an attempt to achieve that goal will impose significant new administrative burdens on taxpayers to comply with more onerous rules. It is also expected that those new rules will increase the tax cost faced by MNEs. If the BEPS proposals succeed in aligning profits with value creation and reducing unintended double non-taxation, then it would seem both perverse and counterproductive to permit tax authorities to ignore or override those results through the adoption of special measures. Special measures should only be considered if the BEPS proposals, when implemented and their effectiveness evaluated over several years, fail to address the issues of aligning returns with value creation and continuing unintended double non-taxation. In that case, the need for special measures would be clearer and the appropriate scope of any special measures would be easier to determine.

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1 USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

2 Discussion draft, Part II, Special Measures, paragraphs 2 and 3, page 38.
If tax authorities are permitted to ignore the proper alignment of profits with value creation that may facilitate a revenue-grab by some tax authorities because they are disappointed with their tax collections even though the results are entirely appropriate. Such a result is also likely to create double taxation since the country to which profits are properly attributable is unlikely to cede taxing jurisdiction. Given the lack of binding dispute resolution, these disputes are unlikely to be resolved.

The likely end result of most of the proposed special measures would be to realign “source” and “residence” taxation.\(^3\) The BEPS project is not intended to address the realignment of so-called “source” and “residence” taxation. Thus, special measures that seek to achieve such realignment should be considered outside of the scope of this project and should be rejected. USCIB believes that all of the special measures other than the first option (a commensurate with income proposal) could result in significant realignment of taxing rights between source and residence countries and should be rejected.

**Non-recognition**

The current Transfer Pricing Guidelines (TPGs) describe two circumstances in which transactions may be disregarded. The first of these is if the substance of the transaction differs from its form.\(^4\) This standard has been deleted from the proposed new section on non-recognition and replaced by a lengthy exposition on the delineation of the actual transaction. As USCIB reads the discussion draft, rather than continuing to be rare (as might be intended by the drafter), recharacterisation/non-recognition would become routine. That is, the first circumstance in which it is appropriate to recharacterise the transaction has been disregarded and replaced by the ability of the tax authorities to “deduce, clarify, or supplement” the contractual terms in virtually every case as they see fit. The overall tone of the discussion draft could lead to an interpretation that the contract is essentially irrelevant, and that tax authorities price the transaction that they perceive to have occurred. USCIB concerns with this standard are discussed in more detail in the specific comments section of this letter.

The new section on non-recognition\(^5\) applies to the transaction between the parties “as accurately delineated.”\(^6\) OECD describes the need for non-recognition and the rule as follows:

“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 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.”\(^7\)

And:

“Since the resulting transactions derive from the environment created by the MNE group, it should not follow that this environment alone determines where profits arise for transfer pricing purposes. Instead it should be determined whether the resulting transactions have arm’s length attributes.”\(^8\)

And:

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\(^3\) USCIB believes that the distinction between so-called “source” and “residence” taxation is meaningless because when countries use these terms they have no consistent meaning. For example, while most countries take the position that the “source” of services income is the place of performance, many others assign source based on the place of consumption. If the country of consumption asserts a greater right to tax services, has taxation been realigned to the source jurisdiction or away from the source jurisdiction? Countries assert that they are the “source” jurisdiction because under traditional international tax principles, the “source” jurisdiction has the primary right to tax and the “residence” jurisdiction has a residual right to tax. This primary right to tax is based on the source jurisdiction being the origin of the income – as opposed to a destination based tax such as a VAT. USCIB’s comment letter on the OECD’s discussion draft on the digital economy goes into detail on this and is relevant here. See pages 1 and 2 and 12 and 13 of the USCIB comment letter on the digital economy discussion draft.

\(^4\) OECD Transfer Pricing Guidelines paragraph 1.65, page 51. Hereinafter OECD TPGs.

\(^5\) Discussion draft paragraphs 83 et seq., page 25.

\(^6\) Discussion draft paragraph 83, page 25.

\(^7\) Discussion draft paragraph 85, page 25.

\(^8\) Discussion draft paragraph 87, page 26.
“An arrangement exhibiting the fundamental economic attributes of 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 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 recognized for transfer pricing purposes.”

Despite some language cautioning against routine non-recognition of the delineated transaction, USCIB is very concerned that this standard will be essentially impossible to apply in practice in a coherent way. Parties “are not always able to protect or enhance their position”. For example, MNEs may shrink or discontinue lines of business. These decisions may be taken in consultation with the affected entities, but for legitimate reasons, may not protect or enhance the positions of the individual entities. Shrinking one entity may occur at the same time that another entity is expanding. These decisions are business – not tax – driven. Such a decision obviously does not protect and enhance the position of both parties to the transaction. Companies may close a plant that is no longer efficient and establish a new plant in a new location elsewhere. That plant may be owned by a different entity in the group and run and staffed by different personnel. Tax authorities routinely challenge the business decisions of MNEs. Companies are challenged on issues as fundamental as the choice of where to locate a plant or where to locate a function. They are also challenged on other issues as well; a local service provider should have been hired. That is, tax authorities often assert that rather than centralizing legal and accounting services MNEs should engage a local firm.

The UK’s proposed Diverted Profits Tax is essentially the UK government telling business that its decision to centrally locate distribution and manufacturing functions in Ireland (instead of the UK) for its customers in the European Union is tax avoidance despite the fact that there may be good business reasons for centralizing those functions and for locating in Ireland. Ireland is typically a first choice of US companies to locate in for a variety of reasons. These reasons include: cost of business including headcount and facilities, a business friendly environment and infrastructure, well educated workforce, English language, EU membership, etc. The continued attack on commissioner structures by the French tax authorities is more of the same. Tax authorities assert the realistic alternative would be a full-fledged distributor. Essentially, tax authorities generally assert that the realistic alternative would be to put more functions in the local jurisdiction, ignoring the actual transaction, when it suits their purposes. Allowing transactions to be ignored based on such a vague standard, will lead to routine non-recognition of transactions that are entered into and performed in good faith for valid business purposes.

The discussion draft would also permit tax administrations to disregard transactions in which an entity trades a risky stream of income for an equivalent, but less risky, stream of income. This is based on the notion that unrelated parties would not engage in these transactions. That unrelated parties would always seek to enhance or protect their position. While it may be true that parties seek to enhance or protect their position, they may not have the power to do so. That is, unrelated parties are rarely bargaining from positions of equal strength and that will affect the outcome of any negotiation. In unrelated transactions, one party may need to make concessions it does not want to make in order to get or keep any business at all. For example, if one party to a transaction provides routine distribution services which could be provided by another person, then the manufacturer whose goods are being distributed may be able to negotiate more favorable terms because of the ability to find another distributor. The manufacturer may be able to retain all or most of any premium profits because of this flexibility. The distributor may have more difficulty substituting other products and thus may be willing to accept a return that does not share in the risk related return even though it may in some sense assist in managing the risk.

Another concern with this standard and with the notion of realistic alternatives is that these concepts are at odds with another focus of the BEPS project -- that is to understand the global value chain and how the interaction between related parties contributes to the overall generation of value. The non-recognition and realistic alternative concepts seem to focus on maximizing the return to the particular entity as distinct from the group, while the focus on the global value chain seems to require a group wide analysis. If the principles of the discussion draft on profit splits are adopted such that the return to the particular entity in fact reflects the contribution to the global value chain, then it will be impossible to apply these other standards which are focused on maximizing the profit in the individual entity.

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9 Discussion draft paragraph 89, page 26.
10 Discussion draft paragraph 84, page 25.
USCIB agrees with the BEPS Monitoring Group’s comments on the OECD’s Dispute Resolution (Action 14) discussion draft. The most important element in dispute resolution is avoiding disputes. It is most effective to avoid disputes in the first instance by adopting clear and simple rules that can routinely be applied. The proposed guidance will lead to disputes that will be very difficult to resolve, as Competent Authorities will not agree on the transaction that is being priced. One country may accept the original transaction, while the other may substitute its own characterization.

Risk

The discussion draft raises issues concerning the global nature of risk. The discussion draft allocates returns from risk to those managing the risk. The managing of global risk is one of the principal functions of senior management and the Board of Directors. Management is responsible for identifying the direction of the business, deciding which ventures to pursue and which to abandon, and developing or acquiring new products or businesses which they believe will be successful. These basic decisions determine whether a company will become and remain successful and by definition must be centrally managed to be effective. All businesses must continuously evaluate and manage these risks. These risks are not managed in a contract manufacturing entity or a contract research and development facility because these entities have no insight into the broader risks facing the entity. Managing risks is the key to the continuing vitality of any business. Any approach that either ignores these risks or allocates them on the basis of a formula would fundamentally misallocate business risk. This approach would divorce taxation from business and economic realities; a result that appears contrary to the goals of the OECD. Additionally, formulaic apportionments carry significant risks of creating their own base erosion problems.

Another fundamental problem with the discussion draft is the notion that unrelated parties do not accept risk that they do not manage. Unrelated parties routinely do this, in some cases because they are willing to accept the risk in exchange for the possibility of high returns (e.g., the passive investor in the hedge fund), and in other cases because they perceive that their interests are generally aligned with the other party. For example, a hotel owner may pay an unrelated management company a fee based on revenues. In this case, both the hotel owners’ and the management company’s interests are served by maximizing revenue from the hotel. An owner of retail real estate may accept rents based on sales in the knowledge that the lessee will be attempting to maximize sales. A pharmaceutical company may license intellectual property for a percentage of revenue. Both the pharmaceutical company and the licensee wish to maximize sales, so their interest are aligned and the licensor would be willing to take on that risk since the licensee will be attempting to maximize its sales to the benefit of the both the licensor and the licensee. These types of arrangement are common. Returns in these types of arrangements reflect assumption of risk by both parties and the return to both parties ought to reflect that shared-risk. That is, both parties should be entitled to an entrepreneurial return.

The discussion draft generally limits contributors of capital, either in the form of ownership of assets or cash, to a routine financial return unless they are also managing the risk related to those assets. This misunderstands investment. Investors are quite willing to invest in valuable assets without the ability to manage those assets and rely on others to manage those assets. This ultimately what corporate shareholders do; that is shareholders invest in a company that they do not control in order to earn the premium returns that a risky business investment may make rather than the more secure financial return of a risk free investment. Fundamentally, corporate risk is borne by ultimate shareholders (individuals) and creditors of the MNE. Shareholders are likely to have very little say about the management and control of risk of the entities in which they invest having deferred that function to the Board of Directors, but ultimately they bear the losses and earn the premium returns. If the BEPS project is about preserving the corporate tax base, then it is necessary to look at the overall purpose and function of the corporate tax. To the extent that the corporate income tax serves as a backstop to the personal income tax, then that should inform the decisions particularly on risk and special measures.

Specific Comments

Update of section D of Chapter 1

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11 Even companies that have been successful over a long period can fail because they fail to manage business risk and change. Kodak is a prime example of the sort of failure.

12 This is why special measure 2 is simply wrong. The independent investor would in all likelihood prefer an investment in the asset owning entity, especially if that asset is unique and valuable. Personnel can always be found to manage the asset.
Section D has been substantially revised. Rather than starting with the notion of comparability, the discussion draft starts with a lengthy section\(^\text{13}\) that is largely new on accurately delineating the commercial or financial relations between associated enterprises. This step takes place before the comparability analysis. Even though the language is new, USCIB understands that the OECD does not believe that the process is new; rather this is how transfer pricing is routinely conducted today. The contract is an element of the transaction, but it is also necessary to examine the conduct of the parties including all the facts and circumstances in delineating the transaction. USCIB believes that if the conduct of the parties is consistent with the contract, the contract should be respected. The fact that the contracts are between affiliates should not affect this fundamental determination.

D.1 Identifying the commercial or financial relations

The discussion draft describes the process of identifying the commercial and financial relations between associated enterprises as involving a very detailed analysis of the contractual terms, the conduct of the parties, their role in the global value chain, and 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.\(^\text{14}\) The terms of the transactions are merely the starting point. If no written terms exist or where the conduct of the parties shows the terms are ambiguous, incorrect or incomplete, "the delineation of the transaction should be deduced, clarified, or supplemented base on the review of the commercial or financial relations as reflected by the actual conduct of the parties."\(^\text{15}\) "Where conduct is not fully consistent with contractual terms, further analysis is required to identify the actual transaction."\(^\text{16}\)

USCIB's is concerned with the level of detail at which transactions are expected to be analyzed. Throughout the draft there is an emphasis on precision (see the quotes above). This is appropriate in high-risk cases, but is probably impractical in routine cases and will permit countries to challenge virtually any transaction, and will lead to proliferating disputes. See for example paragraph 2 which requires examination of all the facts and circumstances, how that interaction contributes to the global value chain, the precise identification of functions, assets and risks. The facts and circumstances should also be taken in context. For example, a term may not be precisely defined in an intercompany agreement because all internal parties to the contract understand precisely how a term is to be applied because that concept is the subject of an internal accounting policy. As such it was considered redundant by the company to define that term in the agreement. A tax examination that considered the context of the relationship would avoid many needless and time consuming disputes.

There needs to be balance between the risk associated with the transaction and the transfer pricing analysis required. Even if the conduct of the parties does not conform in all respects to the contract, in most cases third-party business functional analogues will exit to define the parameters of the relationship and transactions. For example, if the ultimate third party transaction is the sale of products into a jurisdiction, then the affiliates involved should be evaluated within the boundaries of a marketing and distribution chain. USCIB supported the recent discussion draft on low-value adding intra-group services and the prior work on MOUs encouraging Competent Authorities to extrapolate from agreed cases to broader guidance that may be made applicable to taxpayers generally. The current discussion draft also does not reference the OECD's recent work on risk assessment. There should be a balance between the cost and burden on taxpayers and (tax authorities) and the benefits to governments. The discussion draft should be modified to reflect this balance.

The example in paragraph 4 concludes that because the contract does not mention “marketing and advertising services” that the contract is incomplete and therefore the transfer price should be based on the conduct of the parties. USCIB believes that this analysis is incomplete. Before concluding that the transfer price must be determined based on a different transaction, the tax authorities should understand the context of how independent parties operate in the particular industry. It may be that independent parties enter into similar contracts under which equivalent functions are performed under similar terms. That is, the marketing and advertising are considered part of the distribution function and available information on comparable distribution chains should provide parameters for pricing transactions within this relationship. The tax authorities should not jump to the conclusion that because the contract is silent or

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\(^{13}\) Discussion draft, paragraphs 1 – 15, pages 4 – 8.
\(^{14}\) Discussion draft, paragraph 2, page 4.
\(^{15}\) Discussion draft, paragraph 3, page 4.
\(^{16}\) Discussion draft, paragraph 5, page 5.
incomplete, that additional compensation must be paid. If in fact the taxpayer has identified comparables that are functionally comparable then an adjustment should not be necessary simply because the contract is deemed “incomplete” by the tax authorities.\textsuperscript{17}

Paragraph 5 of the discussion draft is based on existing paragraph 1.53 of the TPGs. It has, however, a much more skeptical tone. It starts with the sentence "It should not be assumed that the contracts accurately or comprehensively capture the actual commercial relations between the parties."\textsuperscript{18} This is followed by an emphasis on detailed analysis of the actual conduct of the parties. "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."\textsuperscript{19} As explained above, it is important that this precision be balanced with the notion of risk assessment and burden. Every transaction is not worth this level of attention. The OECD should consider some materiality thresholds before requiring this level of analysis.

Under the discussion draft there are no longer only two cases in which recharacterisation is appropriate. Rather delineation of the transaction would replace the substance over form standard and the second standard would be modified. Delineation of the transaction could amount to a recharacterisation/non-recognition of the transaction because the transaction as described in the contract does not conform exactly to the transaction that took place in the opinion of the tax authorities. This could cause many transactions to be recharacterised without the protection of current TPGs which state that such recharacterisation should only apply in exceptional cases. This comment is related to the precision comment above. Care needs to be taken that good faith transactions are not ignored simply because they deviate from the written contract in certain non-essential terms. Delineating the transaction should not be a license for governments to reconfigure every intra-group transaction. Adopting this standard could effectively read Article 9 out of the Model Treaty and result in an Article 7 analysis for all related party transactions.

Paragraph 6 seems to have an example that would involve recharacterisation of the transaction under the current TPGs\textsuperscript{20}, although this is not labeled as recharacterisation or non-recognition in the discussion draft. The license is essentially ignored and the transaction that is priced is the transaction that the tax authorities believe took place. USCIB believes that by whatever name is applied this is a recharacterisation of the transaction and should, as under the current TPGs, only occur under exceptional circumstances. S’s license could and should be respected and P should be compensated for its services to S.

Paragraph 7 of the discussion draft involves the application of the transfer pricing rules to commercial or financial relations that "may not have been identified by the taxpayer, but that nevertheless may result in a transfer of value".\textsuperscript{21} In such a case, all aspects of the transaction would need to be deduced from available evidence of the conduct of the parties. In particular, the discussion draft mentions technical assistance, creation of synergies through deliberate concerted action and the transfer of know-how through the secondment of employees or otherwise.

USCIB has two comments on paragraph 7. First, as a practical matter the transfer of know-how may be impossible to track. If engineers employed by five different entities located in five different countries hold a conference call to resolve a technical issue, they may share how-know among the members of the group. It is not clear how even the most compliant taxpayer could track this exchange of information and price it. The intangibles report distinguishes valuable know-how from other know-how that is not entitled to a premium return that distinction should be clearly adopted here.

Second, the OECD should be clear about the distinction between an employee’s special skills and company know-how. For example, a welder may have a special skill that makes him valuable and seconding such an employee would

\textsuperscript{17} It is unlikely that a contract whether between related or unrelated parties would cover every conceivable circumstance. If contracts between related parties are required to do so to avoid challenge, then related party contracts will look like transfer pricing reports and be much more difficult to administer than unrelated party contracts.
\textsuperscript{18} Discussion draft, paragraph 5, page 5.
\textsuperscript{19} Discussion draft, paragraph 5, page 5.
\textsuperscript{20} OECD TPGs paragraph 1.65.
\textsuperscript{21} Discussion draft, paragraph 7, page 6.
potentially provide his skill set to the enterprise to which he is seconded. This should not, however, be considered a transfer of know-how. Know-how ought to be limited to something that the company has an interest in protecting, such as a trade secret that the individual may have knowledge of, rather than an individual’s skill set.

Integration and fragmentation

The discussion draft’s functional “analysis focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities include decision-making, including decisions about business strategy and risk management .... In particular, 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 the parties make to value creation.”

The introduction also focuses on the ability of a MNE to fragment even highly integrated functions “secure in the knowledge that the fragmented activities are under common control for the long term and are co-ordinated by group management functions.” When conducting a functional and risk analysis to identify the commercial or financial relations in fragmented activities, it will be important to determine whether those activities are highly interdependent, and if so, the nature of the interdependencies and how the commercial activity to which the parties contribute is co-ordinated.

The options realistically available analysis requires each separate entity to consider alternative transactions that would produce the best result for that individual entity. Thus, the discussion draft seems to require several different ways of looking at each actual transaction, plus the necessity of considering alternative transactions that might change the profit allocation. In reality most alternative transactions presented by tax authorities profess to put additional risks and functions into their jurisdiction. In conjunction with that shift tax authorities immediately jump to the conclusion that the shift creates additional local profit without any consideration of the additional expenses that the local entity would be responsible for due to duplication of efforts across multiple entities. An accurate review of alternative transactions must consider both. The burden posed by these requirements is essentially infinite and there is no guarantee that on audit the tax authorities will still not reject the transaction and substitute another. Again, there needs to some notion of balance, that this level of analysis should only be required in the most complex and financially significant cases. Again, the OECD should consider some materiality thresholds before requiring this level of analysis.

D. 2 Identifying risks in commercial or financial relations

The discussion draft makes a number of points concerning the identification of risks. These include: "identifying risks goes hand in hand with identifying functions and assets; identifying risks is critical because of the allocation of risks affects how profits and losses are allocated; risks can be hard to identify.

In identifying the allocation of risk attention should be paid to how the parties actually manage the risk.

The discussion draft states that "between third parties, the assumption of risk without the control exerted by management over the risk is likely to be problematic. The discussion draft gives two reasons for this. First, it would be difficult for the party assuming the risk to determine the additional return necessary to accept the risk. Second, that allocation would create moral hazard that the person with the ability to control the risk would have no incentive to do so. The discussion draft concludes that "it generally makes more sense for the parties to be allocated a greater share of those risks over which they have relatively more control.” This is emphasized further later in the discussion draft.

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22 Discussion draft, paragraph 16, page 8.
23 Discussion draft, paragraph 21, page 9.
24 Discussion draft, paragraph 21, page 8.
25 Discussion draft, paragraph 36, page 12.
26 Discussion draft paragraph 37, page 12.
27 Discussion draft paragraph 38, page 12.
28 Discussion draft paragraph 38, page 13.
29 Discussion draft paragraph 38, page 13.
30 Discussion draft paragraph 38, page 13.
which provides: "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."\(^{31}\)

USCIB believes that companies accept risks that they do not control on a regular basis and price that risk into their contractual agreement with the other party. They may attempt to hedge those risks to minimize the potential downside, but the notion that parties need to control risk to accept it is flawed. Companies will certainly try to understand the risks they are accepting but in many cases will accept risks that they can neither identify nor understand.

As a recent example, the price of oil and gas has fluctuated dramatically. That fluctuation is due to geopolitical events beyond the control of any MNE, companies across industries may be harmed by or profit from these fluctuations. To some extent the price fluctuations may be managed by hedging but to some extent companies are simply exposed to this risk and that risk is part of doing business. Some companies may fail as the result of these price swings which are beyond their control.

As another example, new technology routinely replaces existing technology and companies adapt or fail. We have already mentioned the failure of Kodak to adapt to the emergence of digital photography and the disappearance of film. How does a company control the risk that its business is obsolete? One response to this risk is to be continuously innovating. As pointed out above the choice of what new products or lines of business to pursue is within the purview of senior management, so that if that innovation is successful it is those decisions that are rewarded. The decisions of senior management need to be implemented by others, both those choices and directions drive premium profits and losses.

The issue of insurance and the contractual allocation of risk is discussed in paragraph 61. The OECD states that "a customer's contract with an unrelated insurance company ... could be perceived as a contractual allocation of risk from the perspective of the customer, but the insurance company will have the relevant capabilities to assess, underwrite, and manage the insurance risk." Thus, the OECD is not seeing the management of the risk as the avoidance of a claim on an individual policy, which would be within the customer's control (careful driving), but the managing of the overall risk to the company.

USCIB believes that the insurance example is inconsistent with how the OECD looks at the risk within the group. That is, within the group, it seems that "driving the car" gets a significant return because that entity is managing the risk. In fact, the function of senior management and the Board of Directors is more analogous to the insurance company. They assess the risk – by determining what business opportunities to pursue or reject, underwrite those businesses, and manage that risk. The discussion draft raises the issue of whether associated enterprises can have different risk preferences while acting collaboratively.\(^{32}\) As a first response to this point, separate legal entities have separate board of directors which have fiduciary duties to the particular company. MNEs are not monoliths, but rather are frequently the result of acquisitions that attempt to combine disparate cultures (both corporate and other). These factors result in company’s within an enterprise having different approaches to business problems. Some MNEs may try to smooth out these differences, but some value the "diversity" of approach. We caution against developing theoretical approaches to transfer pricing concerns based on one interpretation of how an MNE might operate.

The issue of risk preferences also raises a more fundamental issue on risk that the draft does not address, which is that corporate risk is borne by ultimate shareholders (individuals) and creditors of the MNE. Shareholders are likely to have very little say about the management and control of risk of the entities in which they invest relying instead on the value judgment of the Board, but ultimately they bear the losses and earn the premium returns. (This would argue for integration of corporate income and personal income taxes rather than elaborate and perhaps unenforceable transfer pricing rules. Even though corporate/shareholder integration is not being considered, USCIB believes it is worthwhile to consider these issues because it should inform the choices on special measures.)

The discussion draft also raises issue of whether it is possible for the "risk-return trade-off" to be sensibly applied in a MNE group.\(^{33}\) The draft questions how the asset transfer can alter the risks assumed by associated enterprises.

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\(^{31}\) Discussion draft paragraph 61, page 21.

\(^{32}\) Discussion draft, box, page 13.

\(^{33}\) Discussion draft, box, pages 14 and 15.
USCIB believes that companies may accept a risk return trade off in the interest of protecting other assets. For example, if a risky asset is transferred and held in one entity and a third party creditor is looking only to that entity for the payment of its debt and the risky asset does not perform, then the other assets of the MNE group are protected from the claims of that creditor. If this arrangement is respected for corporate law purposes, it also ought to be respected for tax purposes. Shifting income between related parties may change the legal rights of unrelated parties. That is if a creditor is only entitled to proceed against only one entity in an affiliated group, changing the tax allocation may change the rights of the creditor and if so, should there be a concern with retrospective application?

D.2.1 The nature and sources of risk

In the transfer pricing context "it is appropriate to consider risk as the effect of uncertainty on the objectives of the business." Every time money is spent or income is generated, uncertainty exists and risk is assumed. Risk has both positive and negative connotations. Management activities are directed at determining what risks the enterprise wishes to take on and how they are to be managed. Risk depends on the context, some risks are more essential to the company's profitability and long-term viability than others.

There are different categories of risk including: strategic risks or marketplace risks, infrastructure or operational risks, financial risks, transactional risks, and hazard risks. Some risks are externally driven and others internally driven. Externally driven risks can be a source of competitive advantage, depending on the company's ability to manage those risks. Like intangibles, "risks which are vaguely described or undifferentiated will not serve the purposes of a transfer pricing analysis seeking to delineate the action transaction and the actual allocation of risk between the parties." (Para. 42, page 16.)

USCIB would like it to be clear that these rules should be reciprocal. That is, tax authorities should not use vaguely defined undifferentiated risk as basis for transfer pricing adjustments.

D.2.2 Allocation of risk in contracts

If a written contract sets out a contractual allocation of risk, it must be determined whether that is consistent with the conduct of the parties. "Where differences exist between contractual terms related to risk and the conduct of the parties, the parties' conduct in the context of the consistent contractual terms should generally be taken as the best evidence concerning the actual allocation of risk." (Para. 43, page 17.)

Paragraph 44 gives an example where currency risk is contractually allocated to a US manufacturer, but the price for the goods is charged in euros, the currency of the distributor. USCIB assumes that the price referred to in this example is the price between the manufacturer and the distributor, not the distributor and the customer. A euro price to the customer would not result in currency risk to the distributor. The discussion draft concludes that the conduct of the parties is not consistent with the contract and therefore the transaction should be delineated by the actual conduct of the parties rather than the contract.

D.2.5 Risk management

Under the discussion draft risk management has 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 risk mitigation." The first two elements are essentially taken from paragraphs 9.23 and 9.24 of the current transfer pricing guidelines. The third element is not part of that guidance.

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34 Discussion draft, paragraph 41, page 15.
35 Discussion draft, paragraph 42, pages 16 and 17.
36 Discussion draft, paragraph 55, page 19.
Paragraph 55 of the discussion draft acknowledges that risk mitigation can be outsourced, but requires the ability to "assess, monitor, and direct the outsourced measures that affect risk outcomes, together with the performance of such assessment, monitoring, and direction."

D.2.6. Actual conduct

Paragraph 60 of the discussion draft provides "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 party's functions enable it to mitigate the risks associated with business activities." This section runs through a number of scenarios including the insurance scenario described above, the unrelated party supplier taking advantage of its distributor, ownership risk, and the relationship between cash investment and risk.

Essentially, all of the examples separate the assets and the management of the risk. They seem to allow the legal owner of a tangible asset only a financing return. This seems inconsistent with the insurance example where it is recognized that having the capital to bear the risk is an important part of risk management.

With respect to cash, the discussion draft recognizes that investors are sometimes willing to make cash investment in a risky business undertaking without any security or guarantee and states that: "if no other risk mitigation measures are available, such as diversification, the investor may wish to be able to assess, monitor, and direct risk mitigation measures to protect its investment." The return to cash and the return to risk management are considered separately. The discussion draft also seems to downgrade the financial capacity to bear risk. Paragraph 66 states that "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."

These rules seem to ignore that ultimately the premium returns ought to be earned by the ultimate individual shareholders and therefore the return to capital ought to greater. That is after all what shareholders provide. Shareholders do not invest in corporate shares to earn a routine financial return but are willing to accept a measure of risk to earn a premium return. They could make much less risky investments if that were their goal, they invest for excess returns and that ought to be taken into account in whatever rules allocate apply to allocate premium returns.

D.4. Non-recognition

Non-recognition is intended to convey the same meaning as the term recharacterisation in the current TPGs. The OECD recommends that "every effort is made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction". Importantly, "where the same transaction can be seen between independent parties in comparable circumstances, non-recognition would not apply ...... the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognized. .... The key question is whether the actual transaction possesses the fundamental economic attributes or arrangements between unrelated parties ... The non-recognition of a transaction that possesses the fundamental attributes of an arm's length arrangement is not an appropriate application of the arm's length principle."

The OECD justifies non-recognition because of the MNE's ability to control which companies own assets, carry out which activities, assume which risks under contracts, and engage in transactions with one another accordingly, in the

37 Page 19.
38 Page 20.
39 Discussion draft, paragraph 63, page 21.
40 Discussion draft, paragraph 64, page 22.
41 Discussion draft, paragraph 65, page 22.
42 Discussion draft, paragraph 66, page 22.
43 Discussion draft, paragraph 83, page 25.
44 Discussion draft, paragraph 84, page 25.
45 Discussion draft, paragraph 84, page 25.
knowledge that the consequences of the allocation of assets, functions, and risks to separate legal entities is overridden by control.46

The interaction of these rules needs to be considered in conjunction with the proposals on interest deductibility. 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 discussion draft, particularly the group wide ratio, would essentially require, to the extent possible, 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. The discussion draft on risk, characterization and special measures 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, to the extent possible, 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 the discussion draft on risk, recharacterisation and special measures 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.

It should be noted that most MNE’s make every effort to comply with the transfer pricing rules and regulations in every country in which they operate. Consider for a moment the consequences of failing to do so results in numerous extended tax audits, litigations of tax controversies, analysis and disclosure of tax provisions, discussions with the company’s auditor and financial management, disclosure to Wall Street, etc. Taken as a whole there is more incentive for MNE’s to be as compliant as possible than to be non-compliant. Given that perhaps it’s the OECD’s rules that need to be clarified to allow for more accurate MNE compliance.

The new test is supposed to clarify the application of the test of commercial rationality.48 This paragraph also interprets the commercial rationality test as only having a single leg: that is the transaction is commercially irrational. The current test does require that structure practically impede the ability to find a price. The discussion draft essentially reads this out of current TPGs.

Paragraph 89 provides that an arrangement exhibits the fundamental economic attributes of arrangements between unrelated parties if it offers 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. If that is not the case, then the transaction would not be recognized for transfer pricing purposes. It is also relevant to consider whether the group as a whole is worse off on a pre-tax basis.49

If non-recognition is appropriate, then "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."50

This section seems to have some internal inconsistencies. If for example a MNE has a buy-sell distributor in a jurisdiction and wishes to convert that to a limited risk distributor, that would seem to be permissible under the axiom that if the relationship is found between independent parties then it should be recognized. It might also violate the rule that the distributor’s position is not enhanced or protected. That is the distributor will be making less profit under the new arrangement (assuming the distributor has reduced risks and functions), such that the arrangement would not be recognized under paragraph 89. Is that what the OECD intends? How will these positions reconciled? Does this give a premium to setting up a tax efficient structure to begin with? Or are economically inefficient business models the goal as long as they produce additional local tax revenues?

46 Discussion draft, paragraph 85, page 25.
47 See the BIAC comment letter on the OECD’s discussion draft on interest deductibility for detailed comments on why this is very difficult to achieve in practice.
49 Discussion draft, paragraph 89, page 26.
50 Discussion draft, paragraph 93, page 27.
We also refer back to the discussion in section of this letter covering non-recognition concerning this issue. Transactions in which one party accepts a less risky return can and do take place between unrelated parties because all parties to a transaction do not have equal say in the outcome of every transaction and the party in the stronger position may be able to negotiate a greater share of the more risky premium returns.

Part II Potential Special Measures

As we stated at the beginning of this letter, the special measures presented in the discussion draft are only described at a very high-level and it is therefore impossible to analyze them and comment on them in any detail. Before adopting any of these options it would be necessary to publish comprehensive drafts with more specific detail and permit an extended period of stakeholder input into those comprehensive proposals.

As we have pointed out throughout this letter, the discussion draft misunderstands the relationship between capital and risk, particularly the willingness of investors to accept risk that others manage. The special measures (other than the commensurate with income option) would potentially increase that disconnect.

We reiterate our belief that no special measures should be adopted until other BEPS Actions have been implemented and evaluated over a period of time, such that the need for those special measures is clearer and the appropriate scope of such special measures can be determined.

USCIB appreciates the opportunity to comment on the discussion draft and look forward to working with the OECD to achieve appropriate outcomes.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)
WSBI-ESBG Consultation Response: BEPS Action points 8-10: Release of discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (Including risk, recharacterisation and special measures)

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ESBG Transparency Register ID 8765978796-80

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WSBI-ESBG is grateful for the opportunity to contribute to the OECD consultation on BEPS Action Points 8-10. Please find below our comments on the draft.

D. GUIDANCE FOR APPLYING THE ARM’S LENGTH PRINCIPLE

Section D.1 “Identifying the commercial or financial relations”

The Discussion draft (henceforth “the draft”) asserts that the process of identifying the commercial or financial relations between associated enterprises follows from examining contractual terms governing those relations in combination with evaluating the conduct of the parties. That is the manner in which the transaction has been formalised by the taxpayer should be reviewed in light of the actual conduct of the parties.

In fact, the draft describes that in transactions between independent enterprises, the divergence of interests between the parties ensures that:

(i) contractual terms are concluded that reflect the interests of both of the parties;  
(ii) the parties will ordinarily seek to hold each other to the terms of the contract; and 
(iii) contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties.

We do not believe that it is correct to assume that the situation would always be different when dealing with contracts between related parties. Additional analysis should only be required if there is evidence indicating that the contracts did not really cover all aspects as would be done within contracts between unrelated parties. Moreover, this analysis is already done with the review of other documentation that the taxpayer must prepare in respect of undertaken related party transactions.

We therefore believe that paragraph 5 which currently states the following “It should not be automatically assumed that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties”, should be amended as follows: “It should not be automatically assumed that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties”.

Paragraph 10 states that “the economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations of the associated enterprises to the delineated transaction can be broadly categorised as follows:

- The contractual terms of the transaction.
- 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.
- The characteristics of property transferred or services provided.
- The economic circumstances of the parties and of the market in which the parties operate.
- The business strategies pursued by the parties.”

It is proposed that the factors described above are included in the contract to be signed between related parties or, alternatively, that the additional documentation to be provided by the taxpayer to the tax authorities outlines the factors not included in the contract.

As with unrelated parties, contracts must be complete, specific and reflect reality. We believe that this should be the starting point in order to avoid costly input and the proposed analysis should be
used as an exception. It should not be assumed that contracts between related parties are entered into differently to how unrelated parties would have done.

D.1.1 Functional analysis

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. The analysis focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities will include decision-making, including decisions about business strategy, and risk management.” .......

.... “In particular, 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.” .......

Paragraph 22. ....“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.” .....

The above excerpts contain points that are repeated throughout all draft comments to the BEPS Actions and although it is very difficult to establish a unique identification between assigned functions and risks assumed, it should be possible to establish a generic guide with an indicative picture where identifying generic functions and risks which thus facilitates the taxpayer to allocate the corresponding weight to each function (and risk taking) within the overall price of a transaction. Functional analysis is a formal obligation to be met by related entities.

D.1.3 Economic circumstances

Paragraph 27. “Arm’s length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made.” ....

....“The facts and circumstances of the particular case will determine whether differences in economic circumstances have a material effect on price and whether reasonably accurate adjustments can be made to eliminate the effects of such differences. More detailed guidance on the importance in a comparability analysis of the features of local markets, especially local market features that give rise to location savings, is provided in Section D.6 of this Chapter and in paragraphs 9.148 to 9.153.” ....

29. ....“The geographic market is another economic circumstance that should be identified. The identification of the relevant market is a factual question.” ....

In relation to this subject situations where a company provides services to a related company in another state where that product does not exist must be taken into account. It is not known whether the sale of such goods or services will succeed in that geographic market. While the Public Discussion Draft refers to business start-ups and the possibility that a company takes losses at baseline until the product is introduced into the market, it would perhaps also help to establish the possibility of setting the option of price review after a period of time (which is considered to be the period of maturity of a product or service in a market) in order to provide greater legal certainty.

D.2 Identifying risks in commercial or financial relations [This section is substantially new]
Moral Hazard:

“A number of issues can be grouped around the term “moral hazard” which refers to the lack of incentive to guard against risk where one is protected from its consequences. 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.”

“In commenting on this point, respondents are invited to consider the following 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?”

WSBI-ESBG believe that moral hazard should not be a differential aspect as it might be considered that both parties act in good faith to achieve the objectives of each of them as should occur between unrelated parties given that otherwise the economic aspect underlying any contract would be altered.

Section D.3. “Interpretation [This section is substantially new]”

Paragraph 80 clarifies that “Formal conditions recognised in contracts may have been tested against conduct, and found not to be aligned with the substantive arrangements.”… “Therefore, the analysis will have set out the factual substance of the commercial or financial relations between the parties and accurately delineated the actual transaction.”

It is very important to emphasise the idea that contracts between related parties must meet the same requirements as those signed with unrelated parties, indicating that the related parties have contracted under conditions of free competition. This should be a basic starting premise. Only if there is any evidence that the parties have acted differently than have agreed in writing, tax authorities may proceed to analyse the behaviour of the parties. This second analysis (second step) is already done as far as the documentation to be provided by companies that perform related transactions are concerned.

Section “D.4. Non-recognition [This section is substantially new]”

Paragraph 83 summarises that “This section sets out circumstances in which the transaction between the parties as accurately delineated can be disregarded for transfer pricing purposes. The section discusses why there is a need for non-recognition when the transaction does not have the fundamental economic attributes of arrangements between unrelated parties, and determines the criteria for non-recognition. The term non-recognition is intended to convey the same meaning to that understood to be conveyed by the term recharacterisation.”

WSBI-ESBG understands this to say that related parties may sign an agreement that does not have an economic purpose in itself and which may only be signed for tax purposes. In this context it might be clearer to emphasise that the reclassification of an operation occurs when an operation is performed only for tax purposes. Such transactions fall more within the legal definition of fraud than in the area of transfer pricing which in essence stipulates that transactions between related parties are agreed at arm’s length.

Section D.7. “Assembled workforce [Section unchanged except for paragraph numbering]”

Paragraph 117: “Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm’s length price for services provided by the employee group or...”
the efficiency with which services are provided or goods produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis. Where it is possible to determine the benefits or detriments of a unique assembled workforce vis-à-vis the workforce of enterprises engaging in potentially comparable transactions, comparability adjustments may be made to reflect the impact of the assembled workforce on arm’s length prices for goods or services.”

WSBI-ESBG believes that this section should also consider the fact that a company may hold qualified personnel because, in most cases, if not all, they have invested over time to train such personnel and to assist them in gaining experience. This initial investment then results in these employees potentially becoming profitable. The existence of such an employee group would not necessarily affect the arm’s length price for services provided.

Section D.8 “MNE group synergies [Section unchanged except for paragraph numbering]”

Paragraph 122: “Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members, depending on whether expected cost savings are, in fact, realised, and on competitive conditions. In other circumstances such synergies may be negative, as when the size and scope of corporate operations create bureaucratic barriers not faced by smaller and more nimble enterprises, or when one portion of the business is forced to work with computer or communication systems that are not the most efficient for its business because of group wide standards established by the MNE group.”

Arguing that related parties may agree different prices because there are some economies of scale or the exploitation of synergies within the group, whether they are planned or not, does not seem entirely justified in the area of transfer pricing, since the same occurs to large companies capable of contracting a large volume of products/services thus gaining access to discounts compared to small and medium enterprises that do not qualify for any discount because of lower contracting capabilities. In our opinion, economies of scale are fully justifiable and do not imply that the pricing would differ from the market price. The question is whether the price charged, depending on the amount of purchases and other conditions such as long-term contracts, payment date, etc. are equivalent to those which would have been agreed between unrelated parties.
About WSBI (World Savings and Retail Banking Institute)

WSBI brings together savings and retail banks from 90 countries, representing the interests of approximately 7,000 banks in all continents. As a global organisation, WSBI focuses on issues of global importance affecting the banking industry. It supports the aims of the G20 in achieving sustainable, inclusive and balanced growth and job creation around the world, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalisation that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. It supports a diversified range of financial services that responsibly meet customers' transaction, saving and borrowing needs. To these ends, WSBI recognises that there are always lessons to be learned from savings and retail banks from different environments and economic circumstances. It therefore fosters the exchange of experience and best practices among its members and supports their advancement as sound, well-governed and inclusive financial institutions.

WSBI represents more than 6,150 financial institutions from 82 countries. At the end of 2011, these institutions operate through more than 227,000 branches and outlets, employ more than 2.2 million people and serve more than 600 million customers. Assets of member institutions amounted to more than US $15.6 trillion at the end of 2011.

About ESBG (European Savings and Retail Banking Group)

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,300 billion, non-bank deposits of €3,480 billion and non-bank loans of €3,950 billion (31 December 2012).

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