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

The Organization for Economic Cooperation and Development on 19 December 2014, issued a non-consensus public discussion draft proposing changes to Chapter I of the transfer pricing guidelines.

The discussion draft addresses BEPS Actions 8, 9, and 10, which concern the development of:

- "Rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation."

- "Rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterized."

- "Transfer pricing rules or special measures for transfers of hard-to-value intangibles."

The discussion draft is divided into two parts, each containing examples.

Part I contains a proposed new draft to replace Section D of Chapter I (Guidance for Applying the Arm's Length Principle) of the OECD transfer pricing guidelines. It increases the emphasis on identifying whether the substance of a transaction is consistent with the contractual relationships by broadly focusing on the economic circumstances of the commercial and financial relations between the parties, as well as enhancing the detailed guidance on performing a functional analysis. A new section on identifying risks in the commercial and financial relationships between the parties has been added. This new material focuses on managing and controlling risk, similar to the emphasis in the revisions to Chapter VI of the transfer pricing guidelines on intangibles, and significantly decreases the importance of contractual allocations of risk.

Part I concludes with new guidance on nonrecognition or recharacterization of the actual transaction that has taken place. This part provides a new requirement that the transaction must possess the fundamental attributes of arrangements between unrelated parties. The example illustrates a transaction that leaves the group worse off on a pre-tax basis and concludes that the transaction lacks the fundamental attributes of an arrangement between unrelated parties, even though many other arm's length elements of the transaction are present.

Part II of the discussion draft sets out options for "special measures." These are circumstances when the guidance might abandon the arm's-length principle to create a simple shortcut to assert a particular allocation of profit. The discussion draft contains five options for which comments are requested. Specific language implementing the options is not provided.

Comments are requested from interested parties by 6 February 2015. There will be a meeting to discuss the proposals 19-20 March 2015.

Guidance on identifying commercial and financial relations

The redrafted Section D of Chapter I proposes that the economically relevant characteristics or comparability factors can be broadly categorized as follows:

- The contractual terms of the transaction.
- The functions performed by the parties to the transaction, taking into account assets employed and risks assumed and managed, including how those functions relate to the wider generation of value by the multinational group to which the parties belong, the circumstances surrounding the transaction, and industry practices.
- The characteristics of the 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.

The second bullet point represents the primary difference between the discussion draft and the current guidance.

The discussion draft emphasizes the conduct of the parties, not their contractual arrangements, in analyzing the functions actually performed, the assets actually employed, and the risks actually assumed.

The discussion draft states that the functional analysis should determine how value is generated by the group as a whole by focusing on the capabilities and contributions of each party to value creation. The functional analysis should identify the economically significant activities and responsibilities undertaken, assets used, and risks assumed and managed by each of the parties. This enhanced functional analysis is intended to play a significant role in determining who bears risk, the characterization of the transaction, and whether profit split is the best method.

The discussion draft expands upon the need to consider other options realistically available to the parties in deciding whether the transaction entered into -- rather than an alternative transaction -- best meets the commercial objectives of the parties, in part, by requiring an examination of the capabilities of the parties.

The discussion draft states that MNE groups may fragment activities into separate group companies that are dependent on central control and coordination to operate effectively. In such a situation, the functional analysis should identify the nature of the interdependencies and how the commercial activities are coordinated. This issue is also important in the discussion draft on profit splits that was also issued in December 2014.

The discussion draft's emphasis on value creation and realistic alternatives could lead to controversy. Both terms could be susceptible to multiple interpretations. For example, what is value? Is value income, competitive advantage, synergies, economic power, asset ownership, or some other measure of value? Similarly, when is an alternative realistic? Does it mean that the parties must review all possible permutations of the transaction and chose only the transaction that maximizes some unknown quantum decided by the tax authorities?

The new guidance extends the concept of 'transactions' to include circumstances in which value is given even though the parties may not have recorded or intended a transaction. Examples are: when technical assistance has been granted, synergies have been created through deliberate concerted action, or know-how is provided through seconded employees. The creation of synergies is also discussed in the discussion draft on profit splits. The discussion draft notes that these transactions are unlikely to be formalized in contracts and they may not appear as entries in the accounting systems, but the process of functional analysis should consider these transactions.

Identification and allocation of risk

The discussion draft emphasizes that identifying risks is a critical part of a transfer pricing analysis, and goes hand in hand with identifying functions and assets. The discussion draft notes that there are difficulties in identifying risks in related-party contracts because many intercompany agreements may lack the divergence of interests that inevitably occurs between unrelated parties and, therefore, the contracts may be less explicit on many risk and risk management issues. The discussion draft states that the conduct of the entities and not the contractual arrangements will determine the transactions to be priced and the allocation of risk between the parties. The discussion draft emphasizes that the ability to control risk is, between third parties, a critical factor in deciding which party enjoys the reward, or suffers the consequence of controlling that risk. Control over risk is defined as the capability to make decisions to take on risk and whether/how to respond to risks. The discussion draft sets out a framework for analyzing risk, taking into account:

- The nature and source, contractual allocation, and impact of risks;
- How each risk is managed and borne within the group, whether in operating companies, by a separate company managing risks, or by a separate company that assesses, monitors, and directs risk mitigation; and
- The transactions undertaken and the conduct of group companies in managing risk relative to operational and contractual arrangements.

In this aspect, the draft follows the same path as has been used in the draft Chapter VI, transfer pricing of intangibles. Greater clarity on identifying and analyzing risk within a complex business model, including the additional examples, will indeed be helpful.

There is detailed additional guidance on sources of commercial risk including strategic or marketplace risks, infrastructure or operational risks, financial risks, transactional risks and “hazard” risks (for example, adverse external events such as natural disasters), together with examples of the potential impact of risk. The discussion draft states that a company’s ability to manage externally driven risk or general business risk is as important as internal risk and is likely to be a source of competitive advantage. The functional analysis should identify (1) these sources of risk, (2) the entity or entities that respond to and manage these risks, and (3) the impact of risk on value creation.

The discussion draft discusses risk management activities and the importance of determining where in the group the capability and functionality exists to manage risks. Risk management comprises both the capability along with the decision making function in three areas: (1) ability to make or decline risk-bearing opportunities; (2) ability to respond to risks as they arise; and (3) ability to employ risk mitigation strategies. The discussion draft states that simply providing a manufacturer with a cost plus or a distributor with a fixed operating margin does not address who performs the risk management activities and who should be compensated for those activities. Rather, the actual conduct of the parties as determined by the functional analysis will control.

The discussion draft states that at arm’s length the mere contractual allocation of risk without the ability to control risk is not likely to occur and, therefore, the mere contractual allocation of risk will not support a risk transfer for transfer pricing purposes. The discussion draft takes the position that among arm’s length parties there may be limited opportunities to transfer core risks because arm’s length parties may be unwilling to share insights on core competencies with third parties and, therefore, their willingness to take on risks related to core competencies will be limited. The discussion draft refers to the principles discussed in this paragraph as “moral hazards” and has requested comments on the role moral hazards should play in the allocation of risk between related parties.

The discussion draft takes the position that just because risks can be transferred does not mean that they would be transferred at arm’s length. The discussion draft states that trading a more certain or lower risk return for a less certain or higher return, the “risk-return-trade-off,” should not be used by itself to justify the appropriateness of the risk transfer. Rather, such a transfer is likely to take place only if the transferee is well placed or better placed to manage risk than the transferor. The discussion draft requests comments whether, under the arm’s length principle, transactions should be recognized if the sole purpose is a risk-return shift. See also the discussion below on non-recognition of transactions.

The discussion draft recognizes that determining the allocation of risk and risk management between related parties is only the first part of a transfer pricing analysis. The second and equally important part is determining how the benchmarks or comparables allocate risk and risk management, compared to the tested party. The discussion draft recognizes that with respect to many routine transactions the benchmarks or comparables may have a similar risk profile and risk management activities. Distributors are used as an example. Additional examples and further elaboration would be helpful, because for many activities the benchmarks or comparables incur and/or manage risks similar to the tested party. In those cases, adjustment for risk or additional compensation for risk management activities would not appear to be required, because the return to the assumption and management of risk is already included in the results of the benchmarks or comparables.

Nonrecognition and recharacterization

The discussion draft sets out new circumstances in which actual transactions may be disregarded by tax authorities for transfer pricing purposes. To date, the guidance allows for the disregarding or recharacterization of actual transactions in only very limited circumstances: (1) the substance of the transaction differs from its form; or (2) the transaction differs from transactions between unrelated parties and the actual structure practically impedes determination of an appropriate transfer price. Current guidance points to the dangers of pricing something other than the actual transaction, something with which many agree.

The discussion draft states that there is a need for nonrecognition because MNEs can fragment their operations into multiple entities with the knowledge that the consequences of allocating assets, functions, and risks to separate legal entities is overridden by control. Therefore, a transaction should be respected for transfer pricing purposes only if it has the "fundamental economic attributes of arrangements between unrelated parties and commercial rationality." The discussion draft suggests that in entering into a transaction each group company should have a reasonable expectation to enhance or protect its own commercial or financial positions, compared to other options realistically available to them. A relevant consideration would be whether the multinational group would be better or worse off overall on a pre-tax basis.

A new example illustrates the nonrecognition concept. In the example, S1 owns a valuable trademark it uses in its business and engages in extensive marketing to enhance and promote the trademark. S1 sells the trademark to S2, a company in a low-tax jurisdiction, for $400 million. S2 employs individuals who have the capabilities to assess, monitor, and direct the use of the trademark. S2 also enters into a contract with S1 to provide extensive marketing that will enhance and maintain the trademark. The royalty to be paid by S1 to S2 will provide S2 with a financing return. S2 has no ability to exploit the trademark other than its contract with S1. The costs incurred by S2 are considered duplicative of the costs incurred by S1, but will be more than offset by the tax savings. The example concludes that S1 has not enhanced its commercial interest by entering into the transaction and would have been better off by not entering into the transaction. Therefore, the transaction lacks the fundamental economic attributes of arrangements between unrelated parties and should not be recognized. The example concludes that the trademark should be considered to be owned by S1.

It is likely that this new approach to nonrecognition will garner significant comment, possibly including the following themes:

- The approach is likely to increase uncertainty, controversy, and potentially double tax since even under the arguably stricter approach previously adopted, experience of tax audits for business reorganizations or asset sales shows that recharacterization is routinely suggested, and this approach is likely to increase the number of those controversies;
- S1 may have substantially increased its commercial and financial position by freeing up cash to invest in other activities and reducing its cost of capital, considerations not included in the example's analysis and therefore be better off;
- Tax authorities could take many paths to recharacterizing a nonrecognized transaction, which could make transfer pricing documentation challenging and lead to the possible imposition of documentation or other penalties.
- The proposal is contrary to the conclusion reached in the proposed guidance in Chapter VI. The analysis in Chapter VI leads to the conclusion that S2 does own the intangible (i.e., not ignoring the actual transaction) but the payment by S2 to S1 would result in the majority of intangible related return arising in S1. Hence, the 'appropriate' intangible return is achieved under proper application of the arm's length principle without resorting to nonrecognition or recharacterisation of the actual transaction.

Potential special measures

The question whether there is a need for "special measures" either within or beyond the arm's length principle to prevent BEPS was raised at the commencement of the BEPS project. At that time, there was concern that application of the arm's length principle permitted base erosion and profit shifting in some circumstances, particularly in the context of intangibles and centralized business models. Those questions were raised before work on interrelated actions – including Action 3 (strengthen CFC rules), Action 4 (interest deductions), Action 8 (intangibles transfer pricing) and Actions 9 and 10 (transfer pricing risk and capital) had progressed. Given those proposed changes, it is possible that the proper application of arm's length transfer pricing principles, together with other proposed changes, means that special measures are not required. Adoption of special measures would amount, in those limited circumstances, to the abandonment of the arm's length principle and the adoption of an alternate form of profit apportionment. This may be a backward step for the application of the arm's length principle, which, while challenging at times, has achieved in most situations the elimination of potential double taxation over many years.

Nonetheless, the discussion draft suggests that special measures may be needed to eliminate any residual BEPS risk because of information asymmetries between taxpayers and administrators, and the relative ease with which MNEs can allocate capital to low-taxed, low-functioning entities.

The discussion draft considers circumstances where it may be necessary to apply special measures to prevent BEPS. It then poses a number of questions commenters are asked to consider. The discussion draft notes that significant design work will be required if such steps are to be taken, and notes that further consideration will also be given to the prevention of double taxation.

The discussion draft proposes special measures for:

- Hard-to-value intangibles sold for a lump sum when contemporaneous robust projections and analysis are not made available to tax authorities. The discussion draft suggests either requiring the taxpayer to prove the robustness of its projection, or adoption of a U.S.-style commensurate with income provision. The clear danger here is that tax authorities that do not accept the arm's length standard may use hindsight to assert that the conditions for application of the special measure are met.
- Inappropriate returns for providing capital by reference to a hypothetical "independent investor" test or "thick" capitalisation by reference to capital global ratios. However, this may be unnecessary in light of work on Action 4, dealing with interest deductions, and Action 8, dealing with intangibles.
- Minimal functional entities that lack the functional capacity to create value and rely on a framework of arrangements with other group companies leading to a mandatory profit split or controlled-foreign-corporation-style apportionment. However this might be unnecessary once the transfer pricing guidelines are amended as a result of Actions 8, 9, and 10.
- Ensuring appropriate taxation of excess (low-tax) returns, including a primary CFC rule and a secondary rule to allocate taxing rights to other jurisdictions. Again, this might be unnecessary in light of amendments to the transfer pricing guidelines as a result of Actions 8, 9, and 10 and the tightening of CFC rules under Action 3.

Conclusive summary and observation from China transfer pricing perspective

The discussion draft is not a consensus document, and there are indications that not all governments have fully embraced the direction taken by the discussion draft. The OECD recognizes that there may be alternative views, and has requested comments on several controversial concepts, such as the notion of moral hazards and the risk-return-trade-off which permeate the new discussion on risk and lead to the inclusion of the nonrecognition section. Companies should review the discussion draft carefully and make any concerns known to the OECD.

This discussion draft continues with OECD's position of focusing on the actual conducts and the contributions of trading parties to value creation when analyzing the functions and risks. As indicated in some of our prior analysis, the above trend is fully in line with China tax authority's view and request to understand the value creation of the whole supply chain.

A long-anticipated section from this discussion draft could be the Potential Special Measures that OECD proposes to tackle BEPS. Meanwhile, the discussion draft provides some more detailed instruction regarding nonrecognition and recharacterization, which is a highly controversial area.

The State Administration of Taxation (SAT) just released the Administrative Measurement on General Anti-Avoidance Rule (GAAR) in December 2014, which also applies the "substance over form" principle and makes use of nonrecognition and recharacterization as some of the adjustment methods.[1] In practice, China's tax authority has been widely applying such methods in transfer pricing investigations, with some examples as below:

- When a taxpayer operates as a toll manufacturer, some local tax authorities require using the comparable contract manufacturers to determine the taxpayer's return.
- When a taxpayer has a significant local team to provide sales and marketing service to its overseas affiliate, the tax authority does not accept the use of the cost plus service charge model but instead views the taxpayer should make a return similar to a distributor.
- For a model with overseas principal and China routine entities, China tax authority proposes disregarding the existence of overseas principal and attributing the residual profit to China entities; alternatively, overseas principal is viewed as only performing limited administration services and is only entitled to limited routine profit.

The above facts again reinforce our observation that China tax authority has been proactively applying many sophisticated concepts/methods in its transfer pricing practice, and fully keeping in pace with the BEPS developments.

[1] The recharacterization was also mentioned in the GAAR section of China's transfer pricing regulation Circular 2 back to 2009.

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