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BEPS Actions 8, 9 and 10: Transfer Pricing Update

On 7 July 2015 the OECD, as part of its work on the Action Plan to address Base Erosion and Profit Shifting (BEPS), provided an update on Actions 8, 9 and 10 in relation to the transfer pricing of intangibles, risk and capital, and other high risk transactions. Collectively, the objective of these Actions is to ensure that the transfer pricing rules and the arm's length principle appropriately align returns with value creation.

The update was provided by the OECD Secretariat in a public consultation meeting. It does not reflect a consensus view from the G20/OECD governments involved but is designed to aid businesses' understanding of the process to finalise the work and provide 'direction of travel' indicators in key areas, such as the transfer pricing of risk.

Deloitte Comments and Business Next Steps

The update sets out the status of the considerable work being undertaken on transfer pricing under BEPS, including the timing and next steps as well as indicators of technical changes from previous discussion drafts in key areas.

The changes are prompted in part by responses received to public consultations.

Businesses will be pleased that the work on risk and recharacterisation is focused in the main on clarifying and refining proposals that received broad agreement in consultations (such as delineating the actual transaction undertaken), removing some impractical and challenging concepts (such as 'moral hazard') and identifying areas where further guidance and examples would be useful. There is a subtle (but welcome) shift of expectation in that (accurately delineated) transactions should be respected for transfer pricing purposes, except where the outcome is not commercially rational.

Businesses will also be pleased that some key further work will be carried out in 2016, with a view to providing adequate time for consideration, public consultation and analysis of the proposals. Areas for further work include: the attribution of profit to permanent establishments to take account of the specific BEPS proposals for revision of the permanent establishment threshold; guidance on when a profit split method will be the most appropriate (businesses will welcome this focus); and pricing of financial transactions.

There will be no new discussion drafts released for comment in August, and the consultation process will restart in September on the work that will continue into 2016. It seems unlikely that there will be a new consolidated set of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ('the Guidelines') before 2017. Formal adoption of new guidance into domestic transfer pricing rules is likely to be piecemeal depending on how each country's rules interact with OECD guidance. In many areas the new guidance is seen as a 'better explanation' of the operation of the basic arm's length principle, and as such may not require law or treaty changes to become effective. There is evidence of the new guidance already being applied to open transfer pricing cases by tax authorities, which can be problematic given the different guidance that existed at the time of the transactions and the pricing analysis. Best practice for businesses is to take account of the revised guidance as soon as possible.

Changes to the Transfer Pricing Guidelines

Chapter I of the Guidelines will be updated to take account of the need to delineate the actual transaction undertaken, risk and recognition of the accurately delineated transaction (from 2015 work) and locational advantages, workforce in place and synergistic benefits (from 2014 work).

Chapter II of the Guidelines will be updated in relation to commodity transactions, which has recently been approved by Working Party 6. This will include consideration of the use of commodity prices under the comparable uncontrolled price (CUP) method, allowing deeming provisions for the pricing date, and providing for access to double tax treaty mutual agreement procedures (MAP).

Chapter V of the Guidelines will be updated for transfer pricing documentation requirements (including country-by-country reporting). This will incorporate the report from September 2014 and the implementation guidance on country-by-country reporting from February and June 2015.

Chapter VI of the Guidelines will be updated in relation to intangibles, including the 2014 work and the current work on hard-to-value intangibles.

Chapter VII of the Guidelines will be updated in relation to low value-adding services. There is broad agreement to implement a 'simplified approach'. To address concerns from some developing countries that levels of services might be too high, a full transfer pricing analysis will be permitted if deductions are higher than a set threshold.

Chapter VIII of the Guidelines will be updated in respect of the current work on cost contribution arrangements. In addition, further work will be undertaken in 2016 in relation to the use of profit splits, transfer pricing of financial transactions, attribution of profits to permanent establishments and work on implementation of the hard-to-value intangibles proposals.

Risk

Delineation of the actual transaction undertaken is key. Clarity will be provided on the relationship between the contractual arrangements and conduct (activities) of the parties. Contractual arrangements form the starting point of the transfer pricing analysis, and understanding the conduct is relevant to assess whether there are contradictions between the contractual arrangements and conduct, to fill in gaps in the contractual arrangements and to interpret the contracts for pricing purposes.

The guidance on risk will form part of the section on performing a functional analysis. A materiality threshold is included, and therefore 'economically significant' risks need to be identified with specificity. Based on comments received, the reference to 'moral hazard' has been removed but the risk-return trade-off is recognised. 'Control' over risk is clarified, and financial capacity to assume a risk is included as a criterion that ranks equally with control when analysing the assumption of risk. If risk mitigation and preparatory work are outsourced, the company controlling the risk should set objectives for the outsourcing, assess whether these are met, and hire (and terminate the arrangements with) the service provider. Merely formalising decisions in, for example, board meetings where documents are signed, does not qualify as exercising a decision-making function sufficient to demonstrate control over risk. The test of 'financial capacity to bear risk' looks at access to funding (assuming the company is independent) as well as equity levels. The analytical framework on risk is revised. If the party assuming the risk does not control the risk or does not have the financial capacity to assume the risk, then the risk will be allocated to the company that has the most control and the financial capacity to assume the risk. The 'special character' of the financial services industry and the interaction with the proposed 2016 work on financial transactions is acknowledged in relation to risk.

Cash Boxes

Transfer pricing 'special measures' are not necessary in relation to capital rich entities with low or no functionality ('cash boxes'). If a cash box is not exercising control over the financial risk that is connected with the provision of funding, then the risk is allocated to the group entity that is performing the control functions. The non-recognition rules may also be applicable. In such cases, the cash box will get no more than a risk-free rate of return for the funding itself. Other BEPS measures may affect cash boxes, such as interest deductions, controlled foreign company rules and the minimum standard on treaty abuse, as well as domestic anti-abuse rules.

Recognition of the accurately delineated transaction

The rules for non-recognition of an actual transaction builds on the existing guidance and links to the concept of commercial rationality. New examples are included that do not depend on behaviour or on moral hazard.

Intangibles

Fundamental changes are not needed to the earlier (2014) work on the transfer pricing of intangibles. There will be some corresponding changes based on the new guidance on risks and recognition of the accurately delineated transaction. Additional guidance on the allocation of the difference between the actual and the expected profits is included, and will be determined by the way the risks play out. Information asymmetry concerns and the risk of mispricing is addressed through the guidance on hard-to-value intangibles.

Profit splits

The scoping of the work to be undertaken benefited greatly from the public consultation on profit splits. There is recognition that the objective remains to identify the 'most appropriate method' for pricing the transaction.

Dispute resolution

There are two key 'building blocks' in relation to dispute resolution. The first is a mandatory minimum standard and an associated monitoring process, and the second is a voluntary commitment to mandatory binding arbitration. The minimum standard recognises that access to MAP should be provided for all transfer pricing cases, even where a treaty's transfer pricing (associated enterprises) article does not specifically refer to it.

Timetable and Next Steps

Working Party 6 will finalise the 2015 transfer pricing work by the end of July. The papers will be formally approval by the OECD's Committee on Fiscal Affairs in September, then the OECD Council and finally the G20 Finance Ministers on 8 October 2015. It is expected that the papers will be published shortly before 8 October.

Mainland China Practice and Observation

As a G20 member, China has been publicly supportive of BEPS initiatives and contributed some key inputs to OECD BEPS work. China SAT has incorporated certain BEPS elements into its day-to-day practices. Currently, the SAT is in the process of revising the transfer pricing regulations, i.e., Circular 2[1]. It is expected that the upcoming revision will incorporate some BEPS concepts and work result, such as location specific advantage, definition of intangibles and so on.

In practice, we have seen that the SAT and some local tax authorities have also taken some BEPS work plans into their practice. For example,

- On 24 April 2014, the State Tax Bureau of the Jiangsu Province (Jiangsu STB) issued a paper entitled *<Administration Plan for International Taxation Compliance in 2014-2015>*, which summarizes Jiangsu STB's stance towards BEPS-like structures and transactions, and highlights some most important tax risks for Chinese affiliates of multinationals.

- Following the series of published official positions and new regulations (i.e., Circular 146[2] and Bulletin 16[3]) promulgated by the SAT relating to outbound payment of intra-group expenses, the State Tax Bureau of the Zhejiang Province (Zhejiang STB) issued the *<Guideline for Administration of Tax Risks on Outbound Payment to Overseas Related Parties>* on 30 June 2015. This is the first local-level guideline to provide further interpretation and measures to tackle the tax risks coming from outbound payments to overseas related parties.

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[1] Circular 2 refers to Guoshuifa [2009] No.2 *< Implementation Regulations for Special Tax Adjustments (Trial)>.*

[2] Circular 146 refers to Shuizongbanfa [2014] No. 146 *<Notice Regarding the Launch of Tax Anti-avoidance Investigations on Remittance of Substantial Amounts of Service Fees and Royalty Payments>.*

[3] Bulletin 16 refers to SAT Bulletin [2015] No.16 *<Bulletin on Enterprise Income Tax Issues concerning Outbound Payment to Overseas Related Parties>*.

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