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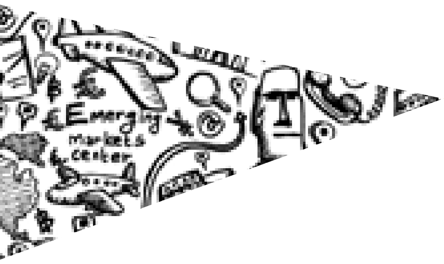

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OECD releases discussion draft under BEPS Actions 8-10 on risk, recharacterization, and special measures

Executive summary

On 19 December 2014, the Organisation for Economic Co-operation and Development (OECD) released a discussion draft in connection with Actions 8-10 (Assure that transfer pricing outcomes are in line with value creation) under its Action Plan on Base Erosion and Profit Shifting (BEPS). The document 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) (the Discussion Draft or the Draft) consists of two parts. Part I is a proposed revision to Section D of Chapter I of the OECD Transfer Pricing Guidelines. The proposals emphasize the importance of accurately delineating the actual transactions. This part of the Draft contains guidance on the relevance and allocation of risk and also guidance on recharacterization or non-recognition, including criteria for determining when it would be appropriate for the actual transaction not to be recognized. Part II of the Draft sets out five options for potential special measures in connection with intangible assets, risk and over-capitalization.

Key features of the proposed Discussion Draft include:

- Updated guidance on the identification of the commercial or financial relations
- New guidance on identifying risks in commercial or financial relations
- New guidance on the interpretation of the actual transaction
- New guidance on recharacterization or non-recognition of a transaction
- Options for potential special measures to reduce the possibilities for BEPS

Building a better working world

The Discussion Draft notes that the views and proposals in the Draft do not represent a consensus view of the OECD, but were released in draft form in order to provide an opportunity for public comments. Written comments on the Discussion Draft are due by 6 February 2015. The OECD intends to hold a public consultation on the Discussion Draft and other transfer pricing aspects of the BEPS project on 19-20 March 2015.

Detailed discussion

Background

BEPS Action 8, 9 and 10, which all relate to assuring that transfer pricing outcomes are in line with value creation, involve several closely related topics. These include the development of:

- Rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members
- Rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties, including implementing transfer pricing rules or special measures to 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 consists of two parts. Part I is a proposed revision to Section D of Chapter I of the OECD Transfer Pricing Guidelines, which emphasizes the importance of accurately delineating the actual transactions and contains guidance on the relevance and allocation of risk and on recharacterization or non-recognition, including criteria for determining when it would be appropriate for the actual transaction not to be recognized. Part II of the Draft sets out five options for potential special measures in connection with intangible assets, risk and over-capitalization.

The current version of Section D of Chapter I of the OECD Transfer Pricing Guidelines (Guidance for applying the arm's length principle) is structured as follows:

- Comparability analysis
- Recognition of the actual transactions undertaken
- Losses
- The effect of government policies
- The use of customs valuations

The Draft proposes to change the structure as follows:

- Identifying the commercial or financial relations
- Identifying risks in commercial or financial relations
- Interpretation
- Non-recognition
- Specific considerations (losses, the effect of government policies and the use of customs valuations)[1]
- Location savings and other local market features[2]
- Assembled workforce
- MNE (multinational entities) group synergies

Part I – Amendments to Section D of Chapter I of the OECD Transfer Pricing Guidelines

Identifying the commercial or financial relations

The Draft contains new guidance on identifying the commercial and financial relations between associated enterprises. A transaction is the result of such relations. The Draft notes two aspects of a comparability analysis: (i) the identification of the commercial or financial relations and the conditions attached to those relations to ensure that the controlled transaction is accurately delineated, and (ii) a comparison between the conditions of the controlled transaction and the conditions of comparable transactions between independent enterprises. The first aspect is dealt with in Chapter I of the OECD Transfer Pricing Guidelines, while Chapters II and III focus on the second aspect.

Where a transaction has been formalized by the taxpayer through written contractual agreements, those agreements provide the starting point for identifying the commercial and financial relations between the associated enterprises. The Discussion Draft provides that where no written terms of a transaction exist, or where the conduct of the parties indicates that the contractual terms are ambiguous, incorrect or incomplete, the delineation of the transaction should be deduced, clarified, or supplemented through the analysis of the commercial or financial relations as deduced from the actual conduct of the parties.

The Draft 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 categorized as follows: (i) contractual terms, (ii) functions performed taking into account assets employed and risks assumed and managed, (iii) characteristics of property and services, (iv) economic circumstances and market, and (v) business strategies. The Draft presents additional guidance regarding the functional analysis, which should focus 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, and the contributions that the parties make to that value creation.

The Draft suggests that features of the parties, such as capabilities and actual contributions, can affect the options realistically available to the parties. Therefore, the process of identifying the economic circumstances of the commercial and financial relations should include consideration of the capabilities of the parties, how under the arm's length hypothesis such characteristics affect options realistically available, and whether similar capability is reflected in potentially comparable arm's length arrangements.

Identifying risks in commercial or financial relations

The Discussion Draft contains a new section with detailed guidance on identifying risks in commercial or financial relations. The Draft defines risk as *the effect of uncertainty on the objectives of the business*. Identifying risks is a crucial part of a transfer pricing analysis, because the assumption of risks affects profit potential and the allocation of risks between the parties affects the allocation of profits losses of the transaction between the parties.

The Discussion Draft provides the following framework for analyzing risk:

- What are the specific risks included in the financial and commercial relations of the parties?
- How are those risks allocated in contractual arrangements? How are the risks assumed? Do the specific risks relate to operational activities from which the risks arise?
- What is the potential impact of those specific risks?
- How is the risk actually managed by the multinational group members?
- Does the party contractually assuming the risk either a) perform the operational activities from which the risk arises, b) manage the risks, or c) assess, monitor and direct risk mitigation?
- What are the actual transactions undertaken? Are the contractual arrangements in relation to the risk allocation, the operational activities to which the risk relates and risk management aligned with the conduct of parties?

The Discussion Draft states that risk-related issues are at the heart of the application of the arm's length principle. In summary, according to the Draft, the issues tend to involve t*he extent to which associated enterprises can be assumed to have different risk preferences while they are also in fact collaborating in a common understanding*. In this respect, the Draft notes that a number of issues can be grouped around the concepts of "moral hazard" and "risk-return." Moral hazard refers to the absence of "incentive to guard against risk" if an entity is shielded from the consequences of the risk materializing. The economic concept of "risk-return trade-off" determines *the 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 OECD requests specific input from the business community on moral hazard and the role of risk-return trade-off in applying the arm's length principle.

The Draft focuses specific attention on risks in the financial services sector. The question is raised whether the discussion of risk is 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.

The Discussion Draft discusses the following issues with respect to risk in more detail:

- **The nature and sources of risk**: Risks can be categorized in various ways, but a relevant framework in a transfer pricing analysis should consider the sources of uncertainty which cause risk. These sources may include, but are not limited to, strategic or marketplace risks, infrastructure or operational risks, financial risks; transactional risks; and hazard risks.
- **Allocation of risks in contracts**: The Draft notes that in line with Chapter IX of the OECD Transfer Pricing Guidelines, it should be considered whether the contractual allocation of risk is consistent with the factual substance of the transaction as revealed in the conduct of the parties. The Draft provides that in identifying the allocation of risk between the parties, attention should be paid to how the parties actually manage the risk identified. Parties should be allocated a greater share of those risks over which they have relatively more control. Control over risk relates to the capability to make decisions to take on the risk and decisions on whether and how to respond to the risk based on 9.23 and 9.28 of the OECD Transfer Pricing Guidelines. Control should not be interpreted as being limited to the decision to adopt risk mitigation measures, because businesses may decide not to mitigate risks in order to create and maximize opportunities.
- **How risks are assumed**: According to the Draft, it is probable that the assumption of core risks is embedded in a multinational group's operational functions and is not always limited to the party in which the outcome of the risk materializes. The functional analysis should assess which party or parties allow the multinational group to react to and manage the effect of risks assumed in its operations. Where functions are in more than one company, the analysis should take into account which functions have more influence on risks assumed.
- **Potential impact of risk**: 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 multinational, the activities that allow the multinational to sustain profits, and the role of the specific entities within the multinational group in contributing to that value. In an integrated multinational group, many group companies can be affected by risk outcomes.
- **Risk management**: The Discussion Draft indicates that risk management does not eliminate risk, but involves the evaluation of risk together with the associated profit-making opportunities and the determination of appropriate risk mitigation strategies. According to the Draft, risk management consists of three elements: *(i) the capability to make decisions to take on or decline a risk-bearing opportunity, together with the actual performance of that decision-making function; (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.* In a multinational group, risk management may be conducted at several levels, including the board and executive committees, line management in business segments, operational entities, and functional departments.
- **Actual conduct**: The Draft emphasizes that assumption of risk by a party will not in itself determine that this party should be allocated the risk for transfer pricing purposes. It is important to question how the risks are controlled in the business and which party's functions allow it to face and mitigate the risks. In determining the appropriate allocation of risk among group members, it should be analyzed which multinational group entities have the capability and

functionality to manage the risks. A relevant factor in considering whether a controlled party should be allocated a risk-return regards the financial capacity to bear the risk. Since multinational groups generally can determine the capital structure of subsidiaries, it should not be a decisive factor. Certain risks can be transferred for a fee at arm's length, examples of which include debt factoring, exchange rate hedges, and fire insurance. However, there are more limited opportunities to transfer core risks, such as strategic, market place, infrastructure and operational risks. The risk-return trade-off should not be used on its own to substantiate the appropriateness of risk transfers, but should be supported by functions: the party taking on the risk should have the capability to manage the risks.

- **Transfer pricing consequences**: In many situations no separate compensation for risk management will be required, because risk management is often included within other transactions. It is important to verify that "comparables" identified have the same level of risk and risk management and if not, that reasonably accurate comparability adjustments are made to eliminate differences.

Interpretation

After identifying the commercial and financial relations and identifying the risks in such relations, the analysis should interpret the actual transaction as accurately delineated. However, in exceptional circumstances the transaction as accurately delineated may be interpreted as lacking the fundamental economic attributes of arrangements between unrelated parties. As a consequence, the transaction is not recognized for transfer pricing purposes.

Non-recognition

The section on non-recognition is substantially new and sets forth circumstances in which accurately delineated transactions can be disregarded or recharacterized for transfer pricing purposes. First, where the same transaction can be seen between independent parties in comparable circumstances, non-recognition would not apply. Furthermore, the transaction as accurately delineated should be recognized, if the transaction possesses the fundamental economic attributes of arrangements between unrelated parties. An arrangement should be considered to include these fundamental economic attributes 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 (including the alternative of not entering into the transaction) at the time of entering into the arrangement. It is also relevant to consider whether the multinational group as a whole is left worse off on a pre-tax basis.

The consequence of non-recognition is the replacement of the taxpayer's structure by an alternative structure that reflects the fundamental economic attributes of arrangements between unrelated parties and that comports as closely as possible with the commercial reality of unrelated parties in similar circumstances.

PART II – Potential special measures

The Discussion Draft states that even with the proposed changes to Chapter I of the OECD Transfer Pricing Guidelines certain BEPS risks may remain and transfer pricing outcomes may not be aligned with value creation. The Draft indicates that these BEPS risks are primarily caused by the information asymmetries between taxpayers and tax administrations and the relative ease with which multinational groups can allocate capital to lowly taxed minimal functional entities (MFEs). According to the Draft, this capital can then be invested in assets used within the multinational group, creating base eroding payments to these MFEs. Therefore, the Draft includes broadly drafted special measures that have been considered to address these risks.

Part II of the Draft presents five options for potential special measures. The first option relates to hard to value intangible. The other options contain measures that take into account inappropriate returns for providing capital. These measures seek to address issues arising from the freedom multinational groups have to control their structures, including the creation and capitalization of companies:

- **Option 1: Hard to value intangibles**: The proposed measure involves a presumption of a price adjustment mechanism where the taxpayer fixed the price as a lump sum or as a fixed royalty rate based on projections and these projections are not contemporaneously documented and made available to the tax administration.
- **Option 2: Independent investor**: In a case where a capital-rich, asset-owning company is dependent on another group company to generate return on the asset, the proposed measure involves the deemed contribution of capital to the company providing the more rational investment opportunity to an independent investor. The result could be that no return is allocated to the capital-rich, asset-owning company.
- **Option 3: Thick capitalization**: This measure involves assessing the capital amount in excess of a pre-determined capital ratio. This measure would reduce the capital-rich, asset-owning company's profitability through deemed interest deductions on the excess capital and would result in deemed interest income in the company providing the excess capital.
- **Option 4: Minimal function entity (MFE)**: It may occur that one of the parties to a transaction has minimal functions. This may lead to the conclusion that the arrangement lacks the fundamental economic attributes that normally substantiate arrangements between unrelated parties. The Draft indicates that it may prove simpler and more effective in dealing with such cases to adopt a special measure that creates a threshold of functionality for parties to a transaction consisting of qualitative attributes (e.g., functional capacity) and quantitative attributes (e.g., small number of employees). The consequence of not meeting the threshold would be the reallocation of the income of the MFE to other group entities.
- **Option 5: Ensuring appropriate taxation of excess returns**: This option involves the application of a primary rule in in the form of a controlled foreign company (CFC) rule and a secondary rule to prevent non-taxation. This option could apply when a CFC earns excess returns in a low tax jurisdiction. The excess returns would be added to the tax base of the parent company. In addition, a secondary rule would apply if none of the parent jurisdictions of a CFC have applied the primary rule, allocating the CFC's excess returns to other jurisdictions based on a pre-determined rule.

The Discussion Draft broadly outlines these options for special measures at this stage, and significant design work will need to be undertaken as the measures are further considered. The OECD requests specific feedback from the business community on these special measures.

Implications

Global businesses should evaluate the implications of the proposed additional guidance on transfer pricing for their intercompany transactions and the documentation thereof. Global businesses also should continue to monitor developments with respect to these BEPS Actions 8, 9 and 10 and may want to consider providing input to the OECD on the Discussion Draft.

Endnotes

1. This part is not proposed to be revised from the current OECD guidance.
2. Sections D.6-8 reflect the revised text relating to locating savings and other local market features, assembled workforce, and MNE group synergies contained in the Guidance on Transfer Pricing Aspects of Intangibles (2014). No comments are requested by the OECD on these sections.

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