TAX EXECUTIVES INSTITUTE, INC.

6 February 2015

Andrew Hickman
Head, Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
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, at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the largest companies in the world.[1]

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."[2] 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 . . . ."[3] 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

Mark C. Silbiger
International President